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RECENT DEVELOPMENTS

CONSTITUTIONAL LAW — CIVIL RIGHTS — DISCRIMINATION BY
PRIVATE INDIVIDUALS IN THE SALE OR RENTAL OF PROPERTY IS
PROHIBITED.

Jones v. Alfred H. Mayer Co. (U.S. 1968)

Petitioners Joseph Jones and his wife filed a complaint in the District
Court for the Eastern District of Missouri alleging that respondent hous-
ing developer, Alfred H. Mayer Co., refused to sell them a home in a
residential development solely because petitioner Jones was a Negro.
Petitioners sought injunctive and other relief, relying in part on title 42,
section 1982 of the United States Code which provides that:

All citizens of the United States shall have the same right, in every
State and Territory, as is enjoyed by white citizens thereof to inherit,
purchase, lease, sell, hold, and convey real and personal property.

The district court sustained respondent's motion to dismiss concluding
that section 1982 applies only to refusals to sell where some governmental
or "state action" is involved and not to similar refusals by private indi-
viduals and, on the same basis, the Court of Appeals for the Eighth
Circuit affirmed. On certiorari, the United States Supreme Court reversed,
holding that section 1982 bars all racial discrimination, private as well as
public, in the sale or rental of property, and that so construed the statute
is a valid exercise of the power of Congress to enforce the thirteenth am-

The Civil War and its aftermath, brought about significant changes
in the area of civil rights since the victory of the northern armies marked

1. 28 U.S.C. § 1343(4) (1964) permits a district court to award "damages
or . . . equitable or other relief under any Act of Congress providing for the
protection of civil rights . . . ."
Circuit did, however, note three rationales which the Supreme Court could adopt in
order to permit a cause of action in a similar case:
It would not be too surprising if the Supreme Court one day were to hold
that a court errs when it dismisses a complaint of this kind. It could do so by
asserting that § 1982 was, because of its derivation from the Thirteenth Amend-
ment, free of the shackles of state action . . . . It could do so by asserting that,
even though § 1982, because of its reenactment, was subject to Fourteenth Amend-
ment limitations, we nevertheless have, on the accepted facts here, enough to con-
stitute state action in the light of the expanding concept of that term. And it could
do so on the ground . . . that state action is no longer a factor of limitation and
that Congress has acted through § 1982 to reach private discrimination in housing.
Id. at 44-45.
the demise of slavery as a legalized institution. In 1865 the thirteenth amendment became effective, providing in section 1 that “[n]either slavery nor involuntary servitude . . . shall exist within the United States . . . .” Under section 2 of the amendment Congress was given the power to enforce the abolition of slavery by appropriate legislation. In the next year Congress exercised this power in passing the Civil Rights Act of 1866, and in United States v. Harris, the Supreme Court noted that what is now section 1982 was enacted pursuant to the thirteenth amendment. One year later in the Civil Rights Cases, the Court, although not specifically concerned with section 1982, stated that the Civil Rights Act of 1866, even as reenacted in 1870, was “clearly corrective in its character, intended to counteract and furnish redress against State laws and proceedings, and customs having the force of law, which sanction the wrongful acts specified.”

Thus, from the first judicial interpretation of the Act in the Civil Rights Cases it appeared that some governmental or state action was a necessary element in the application of section 1982. This position was reinforced in Buchanan v. Warley when the Supreme Court interpreted section 1982 as requiring proof of state action. In effect, the Court was applying the standards of the fourteenth amendment, which had already been clothed with a state action requirement, rather than those of the thirteenth amendment, which was recognized to have application to individual actions. A similar view was expressed in Hurd v. Hodge

7. U.S. Const. amend. XIII, § 2.
8. Civil Rights Act of 1866, ch. 31, §§ 1, 2, 14 Stat. 27. Section 1 of this Act is the predecessor of 42 U.S.C. § 1982. Section 2 of the Act provides for criminal punishment of any person who deprives another of any right secured or protected by the Act, when accomplished "under color of any law, statute, ordinance, regulation, or custom . . . ." These sections were reenacted 2 years after ratification of the fourteenth amendment in the Enforcement Act of 1870, ch. 114, § 18, 16 Stat. 144.
10. Id. at 640.
11. 109 U.S. 3 (1883).
12. Id. at 16. But cf. Jones v. Alfred H. Mayer Co., 379 F.2d 33 (8th Cir. 1967), where the court stated that:
   [T]he reasoning of the Civil Rights Cases is in the process of reevaluation, if not overruling, and . . . a court may not need to stretch to find state action if appropriate congressional legislation is present.
   Id. at 42:
13. 245 U.S. 60 (1917).
14. Section 1 provides in part: "No State shall . . . deny to any person within its jurisdiction the equal protection of the laws." U.S. Const. amend. XIV, § 1 (emphasis added). Section 5 provides: "The Congress shall have power to enforce, by appropriate legislation the provisions of this article." U.S. Const. amend. XIV, § 5. The state action requirement has evolved from the wording of the amendment — "No State shall . . . deny . . . ."
16. Id. at 20.
17. 334 U.S. 24 (1948). In Hurd state action was found in the plaintiff's use of a federal court in attempting to enforce an agreement between white, private individuals to keep Negroes out of a residential area.
which, in dictum, interpreted Corrigan v. Buckley to mean that section 1982 only applies to state action. Corrigan held, however, only that private individuals were permitted to contract with one another to control the disposition of their property, but did not resolve the issue of whether section 1982 prohibits an actual refusal to sell to a Negro by private parties.

Against this background of dicta imposing a requirement that a plaintiff prove state action in cases in which racial discrimination was alleged under section 1982, the instant case squarely confronted the Supreme Court, for the first time, with the issues of whether section 1982 prohibits purely private discrimination on the basis of race in the sale or rental of property and whether Congress in the first instance properly had the power to enact that section of the Civil Rights Act of 1866.

Mr. Justice Stewart, writing for the majority, concluded from a study of the congressional debates preceding the Civil Rights Act of 1866 and from the structure and language of the Act itself that section 1 of the Act, from which section 1982 was evolved, was intended to be applicable to private as well as to governmental action. In the Civil Rights Cases it was recognized that Congress passed the Civil Rights Act of 1866 to further the objectives of the thirteenth amendment to destroy the "badges and incidents of slavery" and to secure the fundamental rights which comprise civil freedom — "the same right . . . to inherit, purchase, lease, sell, and convey property, as is enjoyed by white citizens." It was additionally stated that legislation under the thirteenth amendment "may be direct and primary, operating upon the acts of individuals, whether sanctioned by State legislation or not . . . ." Thus, the fact that the Court

18. 271 U.S. 323 (1926).
19. Id. at 331.
20. One other federal court faced this issue and held that a wholly private conspiracy of white citizens to prevent a Negro from leasing a farm violated section 1982. United States v. Morris, 125 F. 322 (E.D. Ark. 1903).
   [I]f § 1 had been intended to grant nothing more than an immunity from governmental interference, then much of § 2 would have made no sense at all. For that section, which provided fines and prison terms for certain individuals who deprived others of rights "secured or protected" by § 1, was carefully drafted to exempt private violations of § 1 from the criminal sanctions it imposed. There would . . . have been no private violations to exempt if the only "right" granted by § 1 had been a right to be free of discrimination by public officials. Hence the structure of the 1866 Act, as well as its language, points to the conclusion . . . that § 1 was meant to prohibit all racially motivated deprivations of the rights enumerated in the statute, although only those deprivations perpetrated "under color of law" were to be criminally punishable under § 2.
23. Id. at 22. See also Robison, supra note 21, at 465, where it was stated:
   [I]t is inappropriate to apply to language formulated in 1866, the concept of state action which came into the law seventeen years later . . . . It is not unreasonable to conclude that the Congress . . . intended, in the first Civil Rights Act, to reach individual conduct as well as state action that effectively impaired the right to purchase property.
24. 109 U.S. at 23. See also United States v. Harris, 106 U.S. 629, 641 (1883),
viewed section 1982 as applicable to the actions of private individuals presented no constitutional problem.25

The majority then turned to the remaining issue:

[Whether] Congress has power under the Thirteenth Amendment to eradicate conditions that prevent Negroes from buying and renting property because of their race or color . . . .26

If this issue was resolved in the affirmative then no federal statute calculated to achieve that objective could be said to exceed the constitutional power of Congress because it goes beyond state action to regulate the conduct of private individuals. The Court concluded that Congress had such power by virtue of the enabling clause of the thirteenth amendment which provided Congress with the power to pass appropriate legislation to enforce the ultimate end of abolishing slavery in the United States.27 This power of Congress was recognized as early as the Civil Rights Cases in which it was explicitly noted that the disability to hold property was an incident of slavery.28 Finally, the Court determined that the Congress in 1866 had not acted irrationally29 in deciding what constituted the "badges and incidents of slavery," and that section 1982 was indeed intended to rectify the injustices related to those incidents.30

Mr. Justice Harlan, with whom Mr. Justice White concurred, argued in his dissenting opinion that the existing precedents were contrary to the Court's view of the statute.81 In addition, it was noted that section 2 of the Act which provided criminal penalties against any person who deprived another under color of law, statute, ordinance, or regulation, or custom, of any rights secured by the Act, was equally open to the interpretation that

25. Jones v. Alfred H. Mayer Co., 392 U.S. 409, 438 (1968). The Court is pointing out that if the legislation was validly enacted under the thirteenth amendment, then the fact that section 1982 applies to individual action is not a constitutional problem.

26. Id. at 438.

27. See United States v. Morris, 125 F. 322 (E.D. Ark. 1903), where the court stated:
[C]ongress has the power, under the provisions of the thirteenth amendment, to protect citizens of the United States in the enjoyment of those rights which are fundamental and belong to every citizen, if the deprivation of these privileges is solely on account of his race or color, as a denial of such privileges is an element of servitude within the meaning of that amendment.

Id. at 330.

28. 109 U.S. at 22. Mr. Justice Bradley, speaking for the majority, did not discuss the constitutional validity of the Civil Rights Act of 1866 under the thirteenth amendment. Mr. Justice Harlan in dissent, however, expressed no doubt as to its validity.

29. The Court's concern for the rationality of Congress is not new. It was recognized in McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819), where the Court stated:
We think the sound construction of the constitution must allow to the national legislature that discretion, with respect to the means by which the powers it confers are to be carried into execution . . . to perform . . . duties . . . in the manner most beneficial to the people. Let the end be legitimate, let it be within the scope of the constitution, and all means which are appropriate, which are plainly adapted to that end, which are not prohibited, but consist with the letter and spirit of the constitution, are constitutional.

Id. at 421.

30. Robison, supra note 21, at 466, makes a similar argument.

31. See pp. 117–18 supra.
it was carefully drafted to enforce rights secured by section 1 among which were the rights to inherit, purchase, and lease real and personal property.\(^2\)
The basis for this contention was the fact that Mr. Justice Harlan interpreted the term "right" as it appears in the Act in a different manner than did the majority. Mr. Justice Harlan felt that the "right" referred to was the right to equal status under the law — the right of equal protection as guaranteed by the fourteenth amendment — in which case the statute would operate only against state-sanctioned discrimination. The majority, on the other hand, felt that the "right" was absolute and thus enforceable through the thirteenth amendment against private individuals.\(^3\) Thus, after his own exhaustive study of the legislative debate preceding the Act, Mr. Justice Harlan concluded that the interpretation employed by the majority was subject to considerable doubt if not entirely untenable.\(^4\) In conjunction with this, it is important to note that Mr. Justice Harlan was careful in supporting his argument to choose those portions of the original congressional debates which made reference to state laws and customs having the force of law.\(^5\)

The contention that section 1982 requires proof of state action has validity, especially when placed in historical context. The dissent was cognizant of the fact that the Act was passed at a time when there was a highly individualistic, laissez-faire spirit permeating American life, and when state "fair housing" laws were nonexistent.\(^6\) In light of this, it is extremely pertinent in analyzing the intended scope of the Act to point out that at the time the Act was passed there was a paucity of criticism\(^7\) of its ramifications in the area of private discrimination in housing. It is therefore not unreasonable to conclude that the Act was not originally intended to reach as far as the instant decision has extended it.\(^8\)

The ramifications of the instant decision, especially in its application to the area of fair housing, are extremely important. This is particularly true since the instant case was decided just 2 months after Congress passed the Civil Rights Act of 1968\(^9\) which contains extensive fair housing provisions under Title VIII.\(^10\) The Court stated, however, that section 1982

\(^{32}\) See note 21 supra for the majority's interpretation of sections 1 and 2.


\(^{34}\) Id. at 473.

\(^{35}\) See, e.g., Cong. Globe, 39th Cong., 1st Sess. 476 (1866) (remarks of Senator Trumbull); id. at 1118-19 (remarks of Representative Wilson).


\(^{37}\) Id. at 475.

\(^{38}\) The dissent also argued on the basis of Hodges v. United States, 203 U.S. 1 (1907), that there is doubt as to the scope of the thirteenth amendment. It was argued that Hodges limited the scope of the thirteenth amendment to apply solely to individual conduct which actually enslaves another; however, the majority explicitly overruled Hodges insofar as it was inconsistent with their views in the instant case.


\(^{40}\) Civil Rights Act of 1968, Pub. L. No. 90-284, 82 Stat. 73, § 804(a) (discrimination on grounds of religion and national origin); § 804(b) (discrimination in providing services or facilities dealing with the sale or rental of a dwelling); § 804(c), (d), (e) (discrimination in advertising or other representations); § 805 (discrimination in financing); § 806 (discrimination in brokerage services).
is not a comprehensive open housing law.\textsuperscript{41} This contention is true to some degree, for if the Court had chosen to reach its conclusion by entirely eliminating the state action concept as it applies through the fourteenth amendment, the result would have been an open housing law of far greater magnitude than is provided for in the 1968 Act,\textsuperscript{42} and to that extent its decision would have nullified the intent and effects of that Act and converted the Supreme Court into a quasi-legislative body.\textsuperscript{43} Petitioners argued that state action was present in the activities of the respondent housing developer since such activities were sanctioned by state zoning and licensing measures.\textsuperscript{44} Although the concept of state action seems to be undergoing judicial reevaluation,\textsuperscript{45} housing developments, even of large sizes, have generally not been labeled as having governmental attributes.\textsuperscript{46} In light of this, it would have been difficult for the petitioner in the instant case to show the existence of state action in respondent's activities. However, since the Court concluded that the racial discrimination in the instant case violated a federal statute enacted within the power of Congress, they found it unnecessary to consider whether such discrimination also violated the equal protection clause of the fourteenth amendment.\textsuperscript{47}

Petitioners also contended that the state action concept should not be applicable to section 5 of the fourteenth amendment which grants Congress the power "to enforce, by appropriate legislation, the provisions" of the amendment.\textsuperscript{48} In view of United States v. Guest\textsuperscript{49} in which six concurring Justices reasoned that section 5 of the fourteenth amendment empowers Congress to proscribe purely private conduct,\textsuperscript{50} this argument might have served as a basis of decision for the Court in Jones. The utilization of this theory would not necessarily have resulted in an effect as sweeping as the complete elimination of the state action concept because, as one commentator has observed, the state action curb could be retained with respect to section 1 of the fourteenth amendment and abandoned as

\textsuperscript{42} Robison, supra note 21, at 462, points out that "[i]f the courts were to hold that section 1 [of the fourteenth amendment], by itself, prohibits racial discrimination, they would either have to apply that holding to all forms of discrimination or devise some limitation on its scope."
\textsuperscript{43} See A. Cox, M. Howe, & J. Wiggins, Civil Rights, the Constitution, and the Courts 30, 53 (1967), where Professor Howe notes in discussing the history of civil rights that if the courts had given sweeping effect to the fourteenth amendment in order to protect the lives, liberties, properties, and equalities of all persons against private injury, this would have extended the power of Congress under the thirteenth amendment even further than anticipated by the abolitionists.
\textsuperscript{45} See 13 Vill. L. Rev. 199, 201 (1967).
\textsuperscript{47} U.S. Const. amend. XIV, § 1.
\textsuperscript{49} 383 U.S. 745 (1966).
\textsuperscript{50} Id. at 761.
to section 5. This approach would allow Congress to decide the scope of a ban on racial bias extending beyond the traditional state action boundaries.\(^1\)

The Court attempted to narrow the application of the instant case by distinguishing section 1982 from the Civil Rights Act of 1968. The former, the Court noted, is a general statute of limited application — applicable only to racial discrimination in the rental and sale of property and enforceable only through the individual initiative of private litigants. The latter statute, under the provisions contained in Title VIII, is a comprehensive and detailed housing law covering a broader range of discriminatory practices\(^2\) and is enforceable through diverse methods of federal assistance.\(^3\)

The dissent, on the other hand, took exception to the Court's efforts to distinguish the two laws and to show that they can exist independently of one another. Mr. Justice Harlan reasoned that the passage of the Civil Rights Act of 1968 presented "one of those rare instances in which an event which occurs after the hearing of argument so diminishes a case's public significance . . . as to justify this Court in dismissing the writ as improvidently granted."\(^4\) In effect, Mr. Justice Harlan thought that the Court in its construction of section 1982 extended the coverage of federal fair housing laws to a point beyond which Congress intended in enacting the Civil Rights Act of 1968.\(^5\) This contention seems to be valid in that, at least where the sale or rental of real and personal property is involved, purely private discrimination because of race or color is now forbidden without the exceptions provided for in the 1968 Act.\(^6\) One such exception is the sale or rental of a single-family house by a private owner provided he does not own more than three such houses at one time, and provided that he does not inhabit the dwelling. It is further provided that after December 31, 1969, this exception will apply only where a dwelling is sold or rented without the services of a broker, agent, or salesman and without the use of discriminatory advertising.\(^7\) Another exception in the 1968 Act is the rental of rooms in dwellings with living quarters accommodating no more than four families, where the owner himself lives on the premises.\(^8\) In light of the instant case, it appears that a remedy will now be available in these circumstances through a private suit under section 1982.

\(^{11}\) Robinson, *supra* note 21, at 463. See also Gressman, *supra* note 5, at 1329-33, 1340, where the author discusses the application of the fourteenth amendment to violations by individuals, and Horowitz, *Fourteenth Amendment Aspects of Racial Discrimination in "Private" Housing*, 52 CALIF. L. REV. 1 (1964), where an argument for the virtual dilution of the state action requirement is presented.


\(^{33}\) Civil Rights Act of 1968, Pub. L. No. 90-284, 82 Stat. 73, §§ 808-11 (assistance through the Secretary of the Department of Housing and Urban Development); § 813(a) (intervention by the Attorney General).


\(^{55}\) Id. at 478.


\(^{77}\) Civil Rights Act of 1968, Pub. L. No. 90-284, § 803(b) (1), 82 Stat. 73, 82.

One commentator has suggested a liberal approach to state action under the fourteenth amendment under which state action could be classified as being constitutional or unconstitutional, depending on the degree of impairment of a given individual's rights in a particular factual situation. For example, if an owner of a small apartment house were privileged under state law to refuse to rent to a Negro, this would probably be constitutional state action because the discriminatory effect would be slight. But if this individual owned many large apartment houses and there were a housing shortage, then unconstitutional state action might be found. Even if the Court chose to use such an approach, it would be difficult to find that racial discrimination by an owner of one private dwelling would be unconstitutional state action since the effect of one owner's discrimination on the Negro's opportunity to purchase other housing and to use other land without encountering further racial discrimination would be slight.

Although the effects of the liberal interpretation of section 1982 in the principal case appear to be widespread, there are at least two factors which may serve to constrain its operation. Initially, it is arguable that section 1982 is limited in its application to infringement of only fundamental or natural rights basically encompassing, as was suggested in United States v. Morris, the rights to hold and dispose of both real and personal property and to work for a living. Under this theory these fundamental rights are considered to be general rather than specific in nature; hence they would include "the right to buy or lease a home but not necessarily the right to deal in a particular store." Secondly, the nature of relief available under section 1982 is still subject to question. Whereas the 1968 Act contains a provision which allows a court to award actual as well as punitive damages, the Court in the instant case did not specifically decide whether the right to such recovery may be implied in a given circumstance under section 1982. However, in Bell v. Hood it was recognized that "where federally protected rights have been invaded, it has been the rule from the beginning that courts will be alert to adjust their remedies so as to grant the necessary relief." It may therefore be presumed that if a plaintiff could show that he had suffered some uncompensated pecuniary injury — which petitioners in the instant case did not show — it would be within the province of the court to award such damages. As was previously noted, if the Court had entirely eliminated the state action requirement, it would have nullified Congress' judgment.

60. Id. at 213.
61. 125 F. 322, 326 (E.D. Ark. 1903). See note 16 supra. See also Civil Rights Cases, 109 U.S. 3 (1883), where it is noted that the rights to inherit, purchase, lease, sell, and convey property are the fundamental rights which comprise civil freedom. Id. at 22.
62. Robson, supra note 21, at 466.
64. 327 U.S. 678 (1946).
65. Id. at 684 (footnote omitted).
66. Search for "State Action" Under the Fourteenth Amendment.
to provide exceptions to the Civil Rights Act of 1968. If the Court were
to award damages or fashion other types of judicial relief (for example,
relief fashioned after the remedies authorized by the 1968 Act) in actions
brought under section 1982 they would be encroaching upon an area of
congressional discretion. By fashioning such remedies in cases which would
not be justiciable due to the exceptions provided in the Civil Rights Act
of 1968, the Court could effectively nullify the intent of Congress in that
sphere by a form of judicial legislation.

One practical problem for a plaintiff who relies either on section 1982
or the Civil Rights Act of 1968 is that of proof. The plaintiff has the
burden of proving that he was discriminated against solely for racial rea-
sons, and meeting this burden of proof will be a difficult task, especially
where sale or rental is refused by an individual homeowner who may have
a variety of excuses for refusing to sell or rent, for example, he was waiting
to see more prospects or decided not to sell at this time or the price
offered was too low. With respect to large housing developers it might be
valuable from an evidentiary point of view to examine the seller’s records
of prospective buyers to determine how many possible sales were not
pursued or were wholly ignored.

Perhaps the most significant aspect of the application of section 1982
will be upon the social habits and customs of individual property owners.
Property rights have throughout history been accorded an almost sacred
position in the law, and it has been suggested that under the justification
of protecting private property rights, one should not be required to sell,
rent, or lease his property to any person if he does not so desire. One
commentator, although specifically concerned with community planning, has
made a pertinent observation concerning an individual’s relationship to his
land. It was stated that the common person is very conservative about
changes in the land, for he is affected by such changes in many habits and
sentiments. In addition, a community plan involves a choice of living
standards, attitudes, schedule, and personal and cultural tone. Such social
habits and customs are not easy to change. In fact, one advocate of in-
vio late property rights has explicitly stated that “[n]o decision of the
Supreme Court is going to make these changes in the social customs and
personal habits of millions of individuals, nor will any act of Congress
make them.” This statement, however, fails to recognize the directive
nature and educational effect of opinions rendered by the Supreme Court
in the area of civil rights. A case such as Brown v. Board of Education,
which judicially eliminated school segregation, certainly can be said to
have had a great educational impact in effecting changes in the customs
and habits of individuals. Both the instant decision and the Civil Rights

67. Civil Rights Act of 1968, Pub. L. No. 90–284, § 810(e), 82 Stat. 73, 86, for
example, places the burden of such proof on the plaintiff.
69. PAUL GOODMAN & PERCIVAL GOODMAN, COMMUNITAS 9, 10 (2d ed. 1960).
70. Sparkman, supra note 68, at 32.
Act of 1968 are also likely to have a great directive effect on social mores and customs.

In conclusion, although the Civil Rights Act of 1968 will apply to some areas heretofore not imbued with state action, the bulk of its protection is afforded in areas where the courts have already found state action. Despite the possible problems which may arise in proving discrimination, the Court in the instant decision has given the victims of discrimination recourse to a method of judicial prohibition of private racial discrimination in the sale or rental of real and personal property without the previously concomitant requirement of establishing state action and without the exceptions provided for in the 1968 Civil Rights Act.  

Steven G. Brown

CONSTITUTIONAL LAW — CRIMINAL PROCEDURE — VOIR DIRE EXAMINATION OF JURORS IN CAPITAL CASES — DISMISSAL FOR CAUSE OF JURORS WHO VOICE ONLY GENERAL OBJECTIONS TO DEATH PENALTY HELD UNCONSTITUTIONAL AS VIOLATIVE OF DUE PROCESS.

Witherspoon v. Illinois (U.S. 1968)

Petitioner was tried for murder in 1960 by the Circuit Court of Cook County, Illinois, and the jury found him guilty, fixing his penalty at death. The following State statute governed the conduct of the voir dire examination:

In trials for murder it shall be a cause for challenge of any juror who shall, on being examined, state that he has conscientious scruples against capital punishment, or that he is opposed to the same.

The Illinois supreme court had previously ruled that under the voir dire statute the prosecution was permitted unlimited challenges for cause against those prospective jurors who "might hesitate to return a verdict inflicting [death]." On the basis of this interpretation, the prosecution successfully challenged for cause nearly one-half of the venire of prospective jurors.

73. For a discussion of how the thirteenth amendment could have been used since its inception as a basis for eliminating racial discrimination see A. Cox, M. Howe, & J. Wiggins, supra note 43, at 30.

3. In all, 47 veniremen out of a total of 95 were excluded on the basis of their beliefs on capital punishment. Only five of the 47 explicitly stated they would never
No attempt was made to ascertain whether the expressed "conscientious scruples" of any particular juror would invariably have compelled him to vote against the death penalty in all cases.

Petitioner's request for post-conviction relief was denied by the Circuit Court and the Illinois supreme court affirmed. Petitioner reversed, and in a six to three decision, affirmed petitioner's conviction but reversed as to sentence, holding that the execution of a death sentence imposed by a jury from which prospective members were excluded for cause solely because they voiced general objections to the death penalty or expressed conscientious or religious scruples against its infliction constitutes a deprivation of life without due process of law. Witherspoon v. Illinois, 391 U.S. 510 (1968).

The Supreme Court first addressed itself to the problem of voir dire examination in capital cases in 1892 in Logan v. United States. In Logan, the procedure of excluding jurors with conscientious objections to capital punishment was upheld on the ground that such jurors, because of their beliefs, would be prevented "from standing indifferent between the government and the accused, and from trying the case according to law . . . ." Challenge for cause on this basis arose as a matter of practical necessity at a time when the sole function of the jury was to decide the guilt or innocence of the accused, since the imposition of the death penalty was a legislative determination automatically imposed upon conviction for certain crimes. Presently, however, in almost all jurisdictions which still retain capital punishment, imposition of the death sentence is left to the discretion of the jury after guilt has been determined. It has been argued that this change in the function of the jury vitiates the historical justification for death qualification, namely, that jurors opposed to capital punishment might not be able to make a fair determination on the issue of guilt knowing that the death penalty was a certainty upon conviction.

vote to impose the death penalty. Six stated that they did not "believe in the penalty" and 39 said that they had "conscientious or religious scruples against the infliction of the death penalty" and against its infliction "in a proper case" and were therefore excluded.

5. 144 U.S. 263 (1892).
6. Id. at 298.
12. In United States v. Puff, 211 F.2d 171 (2d Cir. 1954), the defendant argued that a modification of the federal statute, under which the death penalty was mandatory for anyone who had "improperly" approached the prosecution of the...
the death penalty is no longer automatic upon conviction for most crimes, the procedure of excluding those opposed to capital punishment at voir dire examinations still persists.\textsuperscript{18}

The decision in \textit{Witherspoon} posed the following questions: (1) Was the "death qualification" procedure as practiced by the Illinois State courts prejudicial to the accused on the issue of sentence? (2) If so, did this prejudice extend to prevent impartiality in the determination of guilt?

As to the issue of sentence, the Court's rationale in \textit{Witherspoon} is couched in terms of due process. In \textit{Irvin v. Dowd},\textsuperscript{14} the Court clearly enunciated the principle that denial of a fair hearing by impartial jurors to the criminally accused violates even minimal standards of due process.\textsuperscript{15} Noting that these requirements of procedural fairness extend to the method of sentence determination as well as that of guilt,\textsuperscript{16} Mr. Justice Stewart, writing for the majority in the instant case, posed the following analogy:

It is, of course, settled that a State may not entrust the determination of whether a man is innocent or guilty to a tribunal "organized to convict." . . . It requires but a short step from that principle to hold, as we do today, that a State may not entrust the determination of whether a man should live or die to a tribunal organized to return a verdict of death.\textsuperscript{17}

The standard the Court attempts to maintain is that of neutrality.\textsuperscript{18} Under this standard those prospective jurors who could never impose the death penalty are clearly not neutral and therefore can successfully be challenged for cause. Where the prospective jurors are only generally opposed to capital punishment, however, exclusion cannot be justified for it is not clear that such general personal views will prevent an impartial determination of sentence in all cases. What in effect the Court concludes is that exclusion of this latter group results in the denial to the accused of an impartial hearing on the issue of sentence since those members of the community most likely to recommend mercy are not represented.\textsuperscript{19}

With respect to the issue of whether the "death qualification" procedure results in an impartial determination of guilt, it is important to note that the Court did not reverse the petitioner's conviction. The majority of the Court expressly rejected the hypothesis that "death qualified" juries are "prosecution prone"\textsuperscript{20} or less than neutral with respect to deciding a
defendant's guilt. Since the Court noted that this particular sociological hypothesis has not as yet become a matter of judicial notice, it would seem that the Court properly rejected it. This rejection, and the Court's subsequent decision not to examine further the possible prejudicial effect of "death qualification" on jurors' ability to impartially decide the guilt issue, is based on the requirement that there be a showing of specific prejudice on the issue of guilt in order to reverse the conviction.

As the concurring opinion of Mr. Justice Douglas aptly points out, however, there is considerable authority to the effect that where large, identifiable groups are systematically excluded from jury service, the right of an accused to a jury representative of a cross section of the community is violated and such a practice of exclusion is prejudicial per se. Exemplary of this view is Ballard v. United States which held that purposeful and systematic exclusion of women, entitled by law to serve, from federal petit and grand juries required the dismissal of an indictment obtained by such a panel without a showing of specific prejudice. Similar cases have held the practice of systematic exclusion on the basis of race and economic status unconstitutional. Relying on these decisions, Mr. Justice Douglas contends that the conviction of Witherspoon should also have been reversed since no showing of specific prejudice on the guilt issue was necessary. Inherent in this contention is the assumption that a jury which is not representative of a cross section of the community is not fit to adjudicate either sentence or guilt.

The concurring opinion not only differs from the majority view as to the standard to be upheld in the jury selection process, but also as to the group that can properly be dismissed on the basis of their views toward capital punishment. Mr. Justice Douglas clearly expressed his point of view:

I see no constitutional basis for excluding those who are so opposed to capital punishment that they would never inflict it on a defendant. Exclusion of them means the selection of jurors who are either protagonists of the death penalty or neutral concerning it.  

23. The Supreme Court seems to consider those opposed to capital punishment as "a large and identifiable group." The Court cites a recent public opinion poll showing that in 1966, 42 percent of the American public favored capital punishment for convicted murderers while 47 percent opposed it and 11 percent were undecided. Witherspoon v. Illinois, 391 U.S. 510, 520 n.16 (1968).
24. "It is part of the established tradition in the use of juries as instruments of public justice that the jury be a body truly representative of the community." Smith v. Texas, 311 U.S. 128, 130 (1940).
25. 391 U.S. at 531.
It appears from this language that the concurring Justice views the jury, once it has been given discretion in regard to the imposition of capital punishment, as a possible vehicle of mercy assuming that the community from which it is selected is so inclined. Exclusion of those jurors, therefore, who are in accord with such community views on capital punishment should accordingly be prohibited.

Mr. Justice White, in dissent, suggests that the decision in *Witherspoon* is in effect an attack on the death penalty itself. His approach posits that neither the neutrality standard nor the "cross section of the community" principle provides an adequate constitutional basis for the Court's decision. The argument is that since the Court did not rule that capital punishment offends the eighth amendment's prohibition of cruel and unusual punishment or that discretion as to its imposition must be delegated to the jury by the legislature, the sentencing process for capital crimes remains primarily a legislative determination. Mr. Justice White, therefore, can see no reason why the legislature should be prohibited from delegating the responsibility of deciding the appropriate penalty to a jury that may impose capital punishment more often than a group chosen on the basis of some other criteria.

With respect to the possible effects of *Witherspoon*, the dissenting opinion of Mr. Justice Black questions whether, in fact, the guidelines presented in *Witherspoon* will produce significantly different juries from those selected under the Illinois statute. Mr. Justice Black apparently views the instant decision as a warning to the States to change present jury selection practices or risk a future decision by the Supreme Court that their murder convictions have been obtained unconstitutionally. The approach the Court might take, however, to link the process of "death qualification" to the guilt issue was not made clear.

The concept of "systematic exclusion" as suggested by Mr. Justice Douglas was used in *Crawford v. Bounds*, a recent Fourth Circuit decision, as a basis for holding the "death qualification" procedure unconstitutional. In reversing both the sentence and the conviction of the petitioner, the court declined to rest its decision solely on due process considerations but ruled that the process of "death qualification" denied the petitioner equal protection of the law. Specifically the court held that:

> [B]elief against capital punishment on the part of jurors who are vested with a dichotomy of functions — the determination of the issue of guilt, and, if guilt is found, the degree of punishment to be imposed — cannot be allowed to disqualify a substantial part of the venire when it is not established that the views of the persons so disqualified

30. *Id.* at 542.
31. *Id.* at 541.
32. *Id.* at 539.
33. 395 F.2d 297 (4th Cir. 1968).
34. *Id.* at 304. The court ruled that the manner of jury selection was patently unfair in that jurors who were opposed to capital punishment were summarily excluded while a juror who stated that he felt it was his duty to impose capital punishment upon conviction was allowed to serve.
will preclude them from making a fair determination on the issue of guilt, aside from the issue of punishment. Such disqualification prevents the jury in its function of determining the issue of guilt from being fairly representative of the community, and thus violates equal protection of the laws.\(^{35}\)

At the basis of the *Crawford* court's equal protection argument are two major contentions. Initially, the court reasoned that defendants in capital cases are denied equal treatment in comparison with that afforded defendants in non-capital cases since the latter group is not tried by juries selected in part on the basis of their views toward punishment. Secondly, the court indicated that no legitimate basis for this unequal treatment exists since the interest of the State in maintaining capital punishment as a viable alternative to life imprisonment cannot stand paramount to the constitutional right of an accused to an adjudication of the guilt issue by a jury which is representative of a cross section of the community.\(^{36}\) The Fourth Circuit concluded, therefore, that only those jurors whose views on capital punishment would interfere with a fair determination of the guilt issue can constitutionally be excluded.

The *Crawford* decision recognized that its view of the proper basis for exclusion may, in some cases, result in the effective nullification of the death penalty:

We are also aware of the danger that if jurors, while agreeing upon the guilt of the defendant, adopt intransigent positions on the issue of punishment, no verdict on either guilt or punishment will be returned since a single verdict is required under North Carolina law, and that this might "result in practical immunity from murder." ... But, the state has *no* constitutional right to the imposition of capital punishment in any case; and a defendant *has* a constitutional protection against systematic exclusion.\(^{37}\)

Thus, it would appear that the *Crawford* mandate will require a fundamental change\(^{38}\) in trial procedure in order to maintain capital punishment as a viable alternative penalty.

Prospectively, it would *not* seem that *Witherspoon* will similarly require a significant change in federal and State procedure for voir dire examination in capital cases. If upon examination a prospective juror indicates general objections to the death penalty, the prosecution will merely have to inquire further as to whether these objections are such as to prevent that juror from imposing capital punishment in all cases. If this is the case, a sufficient basis for challenge for cause will be established.

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35. *Id.* at 308.
36. *Id.* at 310 n.14a.
37. *Id.* at 312.
38. *Id.* The court suggested as a possible solution that North Carolina adopt a two-trial system which permits a second jury to pass on sentence and a first jury to return only a verdict of guilt if the first jury is in disagreement as to punishment. California, Connecticut, New York, and Pennsylvania have adopted this procedural device. CAL. PENAL CODE § 190.1 (West Supp. 1967); CONN. GEN. STAT. ANN. § 53-10 (1968); N.Y. PENAL CODE § 125.35 (McKinney 1967); PA. STAT. ANN. tit. 18, § 4701 (1963).
From a pragmatic point of view it is important to note that the decision in *Witherspoon*, was made fully retroactive, whereas the *Crawford* court did not address itself to this question. In those cases, therefore, where the death penalty was imposed by a jury from which prospective members were excluded for cause solely because they voiced general objections to the death penalty, the death sentence must be reversed and a new hearing on sentence granted. However, the issue of sentence will not be tried again in those cases where only life imprisonment was imposed, even if the "death qualification" procedure was in direct violation of the *Witherspoon* doctrine.

The decision in *Witherspoon* does not represent an attack on the "death qualification" procedure per se. Rather, the question before the Court concerned the degree of opposition to capital punishment necessary to sustain a challenge for cause. The decision represents an attempt by the Court to establish definitive guidelines for voir dire examinations that are in conformity with the presently expanding requirements of due process at the pre-trial stage. Whether the Court will at some future date expand the decision in *Witherspoon* to encompass the rule in *Crawford* will depend largely on the course of action taken by the States in regard to jury selection procedure. If, in fact, the Court concludes that "death qualification" results in a jury "less than neutral with respect to guilt," and thus orders reversal of convictions, it is not likely that this will be done on a retroactive basis since the practical difficulties of absent witnesses and preservation of evidence in granting new trials on the issue of guilt would be overbearing.

Finally, it is most important to note that nothing in the *Witherspoon* decision prevents a State from allowing the trial judge to disregard a jury's finding that life imprisonment rather than death be imposed or from, as the dissenting opinion of Mr. Justice White suggests, replacing the requirement of unanimous jury verdicts on the sentence issue with the less stringent requirement of majority decisions. Implicit in the decision in *Witherspoon*, therefore, is the ruling that a defendant does not have a constitutional right per se to have the sentence issue adjudicated by a jury. The States may effectively vitiate the nullifying effect of the *Witherspoon* doctrine on capital punishment by simply refusing to allow the jury to

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39. 391 U.S. at 523 n.22.
43. The sixth amendment requirement of an "impartial" jury is now applicable to the States because of the incorporation of the jury clause of the sixth amendment into the due process clause of the fourteenth amendment. *Witherspoon* v. Illinois, 391 U.S. 510, 529 (1968) (Douglas, J., concurring); Duncan v. Louisiana, 391 U.S. 145 (1968).
44. 391 U.S. at 518 n.12.
45. Id. at 542 n.2.
make the sentence determination. If this is the course the States pursue, the Supreme Court may feel it necessary to address the problem of capital punishment on the merits and to decide whether its imposition in particular or all cases violates the cruel and unusual punishment clause of the eighth amendment.\textsuperscript{46}

\textit{David J. Griffith}

\textbf{CONSTITUTIONAL LAW — LIMITING INSTRUCTIONS — DESPITE USE OF LIMITING INSTRUCTIONS ADMISSION OF CODEFENDANT'S CONFESSION AT JOINT TRIAL HELD VIOLATIVE OF SIXTH AMENDMENT CONFRONTATION CLAUSE.}

\textit{Bruton v. United States} \textit{(U.S. 1968)}

Petitioner Bruton and one Evans were jointly tried and convicted of the federal crime of armed postal robbery.\textsuperscript{1} At the trial a postal inspector who investigated the case testified that Evans orally confessed to him that he and the petitioner committed the robbery. The trial judge instructed the jury that although Evans' confession was competent evidence against Evans there was no doubt that it was clearly inadmissible as hearsay against the petitioner and therefore was to be disregarded in determining petitioner's guilt or innocence.\textsuperscript{2} On appeal, the Eighth Circuit set aside Evans' conviction since the confession should not have been used against him;\textsuperscript{3}

\textsuperscript{46} In Rudolph v. Alabama, 375 U.S. 889 (1963), the Supreme Court denied certiorari on the issue of whether the eighth amendment prohibits the imposition of the death penalty on a convicted rapist. It is submitted that the Court may in the near future rule that the taking of human life to protect a value other than human life is violative of the eighth amendment. The more difficult question, of course, is whether the imposition of capital punishment can be held unconstitutional on eighth amendment grounds where the crime being punished involves the taking of human life.

\begin{itemize}
  \item \textbf{1.} 18 U.S.C. § 2114 (1964).
  \item \textbf{2.} The trial judge's instructions were sufficiently clear in stating that Evans' admission implicating petitioner if used, can only be used against the defendant Evans. It is hearsay insofar as the defendant George William Bruton is concerned, and you are not to consider it in any respect to the defendant Bruton, because insofar as he is concerned it is hearsay.
  \item \textbf{3.} 391 U.S. at 125 n.2. The instructions continued:

\begin{quote}
  A confession made outside of court by one defendant may not be considered as evidence against the other defendant, who was not present and in no way a party to the confession. Therefore, if you find that a confession was in fact voluntarily and intentionally made by the defendant Evans, you should consider it as evidence in the case against Evans, but you must not consider it, and should disregard it, in considering the evidence in the case against the defendant Bruton.
\end{quote}

\textit{Id.} (emphasis added).

1. The trial began June 20, 1966, 1 week after the decision in \textit{Miranda v. Arizona}, 384 U.S. 436 (1966), \textit{noted in 12 Vill. L. Rev. 198} (1966). Miranda and its companion cases were therefore applicable in determining the admissibility of Evans' confession. On the merits, the court of appeals held that the admissions to the postal inspector "were tainted and infected by the poison of the prior, concededly unconstitutional confession . . . ." \textit{Evans v. United States}, 375 F.2d 355, 361 (8th Cir. 1967), \textit{rev'd sub nom., Bruton v. United States}, 391 U.S. 123 (1968).
however, relying on *Delli Paoli v. United States,* the court affirmed as to the petitioner since the jury was properly instructed to disregard Evans' inadmissible confession as it related to petitioner's guilt. On certiorari, the United States Supreme Court in a six to two decision reversed holding that

because of the substantial risk that the jury, despite instructions to the contrary, looked to the incriminating extrajudicial statements in determining petitioner's guilt, admission of Evans' confession in this joint trial violated petitioner's right of cross-examination secured by the Confrontation Clause of the Sixth Amendment.

**Bruton v. United States, 391 U.S. 123 (1968).**

Limiting instructions have long served as a judicial tool to protect parties to a litigation when certain evidence is deemed admissible on one issue yet inadmissible on another, or admissible against one defendant but not another. More particularly, instructing the jury to consider evidence only for its legally proper purpose has served, in theory, to protect the objecting party from the specific prejudice which would otherwise require exclusion of that evidence. The confrontation clause of the sixth amendment is similarly a trial protection in criminal cases in that it secures the defendant's opportunity to cross-examine the trial witness and insures that the jury will have the opportunity to observe the testifying witness' demeanor. Focusing more directly on the opportunity to cross-examine, cases interpreting the confrontation clause have held that absence of this opportunity results in the denial of an accused's sixth amendment right to confront his accuser. In 1965 the Supreme Court in *Pointer v. Texas* recognized that this clause of the sixth amendment applies to the States through the due process clause of the fourteenth amendment.

The precise issue facing the Supreme Court in *Bruton* was whether the conviction of a defendant at a joint trial must be set aside due to denial of his sixth amendment right of confrontation, despite the fact that the jury was specifically instructed to disregard a codefendant's inculpating yet inadmissible confession. Faced with the very same issue 11 years earlier, the Supreme Court in *Delli Paoli v. United States* held that the use of sufficiently clear limiting instructions in a joint trial made it "reasonably possible" for a jury to disregard a confessor's extrajudicial statement that

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6. Mr. Justice Marshall took no part in the consideration or decision of the case.
10. 5 J. Wigmore, * supra* note 8, § 1395.
his codefendant participated with him in committing a crime. 14 Delli Paoli was grounded in the presumption that the jury in such circumstances had the ability to follow the trial judge's limiting instructions to disregard references to the codefendant and to consider the evidence only for its proper purpose. Consequently, no constitutional question could arise under the confrontation clause since the case was then treated as if the confessor made no statement or reference to his codefendant.

The basic premise of Delli Paoli — the validity of a juror's ability to place inadmissible incriminating evidence out of his mind in prejudicial circumstances — was first rejected by the United States Supreme Court in Jackson v. Denno. 15 In Jackson, the Court held that a jury, once it decided that the defendant's confession was inadmissible because involuntarily given, could not then be asked to disregard that confession in determining that same defendant's guilt on the merits. 16 Although the Court in Jackson was faced with an extremely difficult situation for justifying the use of limiting instructions, the majority opinion reflected the Court's view toward the use of limiting instructions in prejudicial circumstances. The majority relied on Mr. Justice Frankfurter's dissent in Delli Paoli wherein he stated:

The fact of the matter is that too often such admonition against misuse is intrinsically ineffective in that the effect of such a nonadmissible declaration cannot be wiped from the brains of the jurors. The admonition therefore becomes a futile collocation of words and fails of its purpose as a legal protection to defendants against whom such a declaration should not tell. 17

The Court's analysis in Bruton closely follows the approach adopted in Jackson. It was recognized in Bruton that a joint trial is a context in which there is the possibility of prejudice to a codefendant where confessions are used; in such a context the jury will not follow limiting instructions and will therefore use an inadmissible confession for an improper purpose. Where the codefendant is inadequately protected from this danger of improper use so as to place a specific constitutional right in substantial jeopardy, then the risk of impairment to that codefendant's rights is too great, and the use of limiting instructions cannot be sanctioned. As noted previously, the rejected procedure in Jackson allowed the jury to determine that a confession was inadmissible because involuntarily given, yet expected the same jury to disregard the inad-

14. Id. at 239.
16. Id. at 388-89.
17. 352 U.S. at 247 (emphasis added). Mr. Justice White, writing for the majority in Jackson, was influenced by Mr. Justice Frankfurter's dissent, when he stated: "[T]he Government should not have the windfall of having the jury be influenced by evidence against a defendant which, as a matter of law, they should not consider but which they cannot put out of their minds." Jackson v. Denno, 378 U.S. 368, 388 n.15 (1964). See also Krulewitz v. United States, 336 U.S. 440 (1949), where Mr. Justice Jackson stated that "[t]he naive assumption that prejudicial effects can be overcome by instructions to the jury . . . all practicing lawyers know to be unmitigated fiction." Id. at 453 (concurring opinion).
possible confession in determining the defendant’s guilt. This procedure placed the defendant’s fifth amendment guarantee against compelled self-incrimination in jeopardy since it did not “adequately protect Jackson’s right to be free of a conviction based upon a coerced confession . . . .”18 The lower court in Bruton followed a procedure similar to the one rejected by the Supreme Court in Jackson in allowing the jury to hear defendant Evans’ confession which implicated codefendant Bruton, and then expecting them to disregard those inculpatory references in determining Bruton’s guilt. Similar to the circumstances in Jackson this procedure also placed a constitutional protection — petitioner’s sixth amendment right to confrontation — in jeopardy since it “added substantial, perhaps even critical, weight to the Government’s case in a form not subject to cross-examination, since Evans did not take the stand.”19 Such an approach does not cast doubt on the capabilities of jurors or the maintenance of the jury system,20 but, rather, squarely faces the jury’s human shortcomings in a particular context. The Bruton court was thereby able to repudiate the underlying rationale of Delli Paoli and to overrule that case as establishing an unsound constitutional doctrine.

In determining the constitutional validity of limiting instructions as a prophylactic device in a particular case, the Bruton opinion suggests proceeding in two steps. First, the trial context and procedures must be examined to find whether, under the circumstances, there exists a likelihood that the jury will not follow the limiting instructions and therefore use the evidence improperly. Secondly, it must be determined whether such an improper use of the evidence will unduly jeopardize the effectiveness of a constitutional guarantee.

In facts similar to the instant case, Justice Traynor, reasoning from Jackson, found the trial context and procedures prejudicial:

Although Jackson was directly concerned with obviating any risk that a jury may rely on an unconstitutionally obtained confession in determining the defendant’s guilt, its logic extends to obviating the risks that the jury may rely on any inadmissible statements. If it is a denial of due process to rely on a jury’s presumed ability to disregard an involuntary confession, it may also be a denial of due process to rely on a jury’s presumed ability to disregard a codefendant’s confession implicating another defendant when it is determining that defendant’s guilt or innocence.21

Although Justice Traynor’s reading of Jackson is cast in terms of due process, his “fairness” rationale was clearly utilized by the majority in Bruton22 to repudiate the principles underlying the holding of Delli Paoli.

18. 378 U.S. at 377.
19. 391 U.S. at 128.
20. Mr. Justice Clark expressed the view that the Court’s holding in Jackson — the jury’s inability to segregate the issues and thereby abide by the limiting instructions — “lends its weight to the destruction of this great safeguard to our liberties.” 378 U.S. at 426 (dissenting opinion).
22. 391 U.S. at 130-31.
In addition, the Bruton Court noted that the recently amended rule 14 of the Federal Rules of Criminal Procedure, authorizing severance of defendants or trials, is based on the theory that the prejudice created by using a codefendant's extrajudicial confession in a joint trial is not eradicable through the use of limiting instructions.23

Once the trial context is found to be prejudicial, the Court's next step is to balance the effect of the jury's inability to follow limiting instructions against the petitioner's specific constitutional rights. It appears that the effect on the outcome of the case is an important factor to the Court's decision, for as the Court noted, the fact that some prejudicial effects may be incurred is not sufficient, in itself, to invoke constitutional safeguards.24 The situation must result in a finding that

the risk that the jury will not, or cannot, follow instructions is so great, and the consequences of failure so vital to the defendant, that the practical and human limitations of the jury system cannot be ignored.25

A factor which the Court apparently uses to upset this balance is not merely the fact that inadmissible evidence is placed before the jury, but that its reliability is inevitably suspect. In Bruton, the unreliability of the codefendant's confession was compounded by its inadmissibility against the confessor; additionally the confessor himself failed to testify or subject himself to cross-examination.26

Reasoning to a denial of the right to confrontation was not a difficult task, assuming the Court's basic premise that the jury is unable to follow limiting instructions. The Court relied on Douglas v. Alabama,27 where the prosecutor read statements from the confession of defendant Loyd under the "guise" of refreshing his memory. Such statements inculpated codefendant Douglas. Loyd, relying on his privilege against self-incrimina-

23. Id. at 131–32.
24. In cautioning against complete abandonment of limiting instructions, the Court stated that
[n]ot every admission of inadmissible hearsay or other evidence can be considered to be reversible error unavoidable through limiting instructions; instances occur in almost every trial where inadmissible evidence creeps in, usually inadvertently. 391 U.S. at 135. See Lutwak v. United States, 344 U.S. 604, 619 (1953) (since the record "fairly shrieks the guilt of the parties" the one wrong admission could not have possibly influenced the jury to reach an improper verdict); Hopt v. Utah, 120 U.S. 430 (1887) (prosecutor's statement as to the number of times the case had been before the courts was not viewed as referring to any previous verdict and therefore was not prejudicial); Fed. R. Crim. P. 52(a) "[a]ny error, defect, irregularity or variance which does not affect substantial rights shall be disregarded." (emphasis added).
25. 391 U.S. at 135.
26. Id. at 136. The Court has found limiting instructions insufficient to maintain the balance in other instances; Throckmorton v. Holt, 180 U.S. 552 (1901) (lengthy trial and uncertainty concerning what evidence was inadmissible); Mora v. United States, 190 F.2d 749 (5th Cir. 1951) (limiting instructions delayed until the final charge to the jury where inadmissible testimony was the only substantial evidence implicating the codefendant). See Holt v. United States, 94 F.2d 90 (10th Cir. 1937) (prejudice created by an inadmissible confession must have influenced the jury since the competent evidence on the conspirator's guilt was far from conclusive).
tion, neither denied nor affirmed that he had made the confession. In finding that Douglas was denied his right to cross-examine secured by the confrontation clause of the Constitution, the Court noted that

[although the Solicitor's reading of Loyd's alleged statement . . . [was] not technically testimony, the Solicitor's reading may well have been the equivalent in the jury's mind of testimony that Loyd in fact made the statement . . . .]28

By analyzing the facts of the instant case to those of Douglas, the Bruton Court reasoned that since Evans' incriminating confession was in fact testified to by the postal inspector and was therefore actually in evidence (as opposed to the nonevidence use of refreshing the witness' memory used in Douglas), even less protection was afforded to petitioner Bruton than was afforded the petitioner in Douglas.29

The majority opinion failed to note, however, the specific alternative procedures available to the courts to protect a codefendant from the prejudicial effects of another's extrajudicial confession. In dissent,30 Mr. Justice White suggested that three choices will be open to the courts and prosecutors in order to escape reversal under the Bruton ruling: (1) the incriminating references to petitioner in codefendant's confession may be effectively deleted;31 (2) if deletion is not feasible, it may be decided that the confession should not be used; or (3) the defendants may be tried separately.32

The importance of the instant decision lies mainly in its effects on conducting joint criminal trials in general, and conspiracy trials in particular, especially in light of the choices available to prosecutors and the courts suggested by the dissent. The arguments offered for joining defendants or trials have traditionally been justified by the policy of judicial economy — joint trials minimize the burden on witnesses, prosecutors, and courts, avoid delays in bringing those accused of crime to trial, and avoid varying consequences for legally indistinguishable defendants.33 The instant case indicates that the justification of judicial economy will not be controlling where the risk of prejudice outweighs its benefits. In accord-

28. Id. at 419.
29. 391 U.S. at 127.
30. Id. at 138-44.
31. Mr. Justice White cautioned that "the deletion must not be such that it will distort the statements to the substantial prejudice of either the declarant or the Government." Id. at 143 (dissenting opinion). For a discussion of effective deletion see Stein v. New York, 346 U.S. 156, 194 (1953); Jones v. United States, 342 F.2d 863, 866 (D.C. Cir. 1964).
32. Theorizing on the practical aspects of such choices, Mr. Justice White stated: To save time, money, and effort, the Government might best seek a ruling at the earliest possible stage of the trial proceedings as to whether the confession is admissible once offending portions are deleted. The failure of the Government to adopt and follow proper procedures for insuring that the inadmissible portions of confessions are excluded will be relevant to the question of whether it was harmless error for them to have gotten before the jury. Id. at 144 (dissenting opinion).
33. Id. at 143 (dissenting opinion).
ance with the rationale espoused in Bruton, where a confession in a joint trial is critical evidence to the government's case or strongly implicates a codefendant, severing the trials would doubtlessly be appropriate and perhaps necessary to preserve convictions. Where the confession is tangentially significant or where the danger of prejudice to the codefendant is slight, judicial economy would dictate joinder but seemingly it would not be proper until there is deletion of all reference to a codefendant as is indicated by Bruton. 34

Criminal conspiracy trials, as previously noted, will also be acutely affected by the rationale supporting Bruton. It is here that the joint or mass trial is employed most frequently since the elements of a conspiracy charge demand that the prosecuting officials prove some concerted action or agreement among defendants in order to obtain convictions. 35 An extrajudicial confession by one party to the conspiracy implicating a coconspirator in a given circumstance may be the prime evidence used to prove the existence of the conspiracy where other evidence is scant. Effective deletion of any reference in the confession to the inculpated codefendant would seriously hamper the prosecutor's ability to prove the element of agreement by limiting his evidentiary tools to circumstantial or extrinsic evidence. If effective deletion is not feasible without imperiling the prosecution's case then the only alternative will be to forego entirely the use of the confession. Due to the practical need for joinder in these cases, severing the trials, especially where the government is attempting to prove the existence of a "gang-size" conspiracy, appears to be an unduly burdensome task and one which bespeaks its own ineffectiveness.

Although the narrow holding in Bruton is based on a denial of confrontation, the due process rationale employed by the Court may have broader implications with respect to the future use of limiting instructions at all trials where a jury's inability to follow the judge's directive results in serious prejudice. If limiting instructions do not afford an accused in a joint trial adequate protection from substantial risk of prejudice resulting from use of a codefendant's confession then, arguably, they may not offer an accused in an individual trial such protection when the prosecutor resorts to using the multiple relevance rule 36 or exceptions to the hearsay rule — especially when the evidence is extremely damaging.

The most criticized example of such use is when a defendant's prior criminal record is introduced into evidence for the purpose of impeaching his credibility. 37 The practice of using past records involving

36. Here evidence may be offered against the accused on one issue whereas it would be inadmissible on another ground. See Michelson v. United States, 335 U.S. 469 (1948); Drew v. United States, 331 F.2d 85, 89-90 (D.C. Cir. 1964); C. McCormick, supra note 8, § 157, at 327; 1 J. Wigmore, supra note 8, §§ 192-94.
37. See Model Code of Evidence, rule 106 (1942); Uniform Rules of Evidence 21; C. McCormick, supra note 8, § 43, at 94; 3 J. Wigmore, supra note 8, § 982, at
any and all types of criminal conduct to impeach credibility generally, as opposed to using only a record of those crimes which specifically involve a lack of veracity, such as perjury, fraud, and forgery, has been subject to question.\textsuperscript{38} Recent studies have established that use of prior criminal records as impeaching evidence not only creates risk of prejudice, but also adversely affects a defendant's chances for acquittal.\textsuperscript{39} It has been argued that the jury in arriving at convictions must have used the evidence irrationally, applying its probative value to the issue of guilt and not credibility. If these studies are correct, the question arises whether the prosecutor has obtained a conviction without having introduced sufficient evidence on the issue of guilt to establish that guilt beyond a reasonable doubt.\textsuperscript{40} It has been argued further that the effects of the prejudice resulting from impeachment by the use of records of prior convictions jeopardizes the defendant's constitutional rights to a fair and impartial jury and to equal protection of the law.\textsuperscript{41} While the question of a fair and impartial jury\textsuperscript{42} could be reached through an analysis of the empirical data contained in the aforementioned studies,\textsuperscript{43} a denial of equal protection of the law could be found where the defendant-witness was cross-examined regarding all prior convictions regardless of their nature. Such a use could lead to unreasonably classifying the defendant as untruthful because of the absence of a reasonable nexus between all crimes and the defendant's veracity.\textsuperscript{44}

It is clear that the principal case has taken a further step toward judicial recognition of the ineffectiveness of limiting instructions where the resultant effect is to sacrifice specifically protected constitutional rights. As a logical extension of \textit{Bruton}, however, it may be argued that despite limiting instructions, the possibility that the jury either considered the evidence on inadmissible grounds or was unable to follow the instructions creates a risk of prejudice so great that the accused is denied a due process

\textsuperscript{38} See 3 J. \textsc{Wigmore}, supra note 8, § 982, at 550.

\textsuperscript{39} H. \textsc{KALVEN} & H. \textsc{ZISSEL}, \textsc{The American Jury}, table 52, at 160-61 (1966). The strength of the evidence was kept constant while the defendants were divided into two groups. The number of acquittals in the first group — those which the jury either knew or suspected had a criminal record — was 27 percent lower than the number in the second group — where the defendant either had no criminal record or the jury was unaware of its existence.

\textsuperscript{40} \textsc{McCormick}, \textsc{Some High Lights of the Uniform Evidence Rules}, 33 Texas L. Rev. 559, 568 (1955).

\textsuperscript{41} Comment, Constitutional Problems Inherent in the Admissibility of Prior Record Conviction Evidence for the Purpose of Impeaching the Credibility of the Defendant Witness, 37 U. Cin. L. Rev. 168, 173-80 (1968).

\textsuperscript{42} In \textit{Baker v. Hudspeth}, 129 F.2d 779 (10th Cir.), cert. denied, 317 U.S. 681 (1942), the court combined both doctrines into the single determination of due process as demanded by the fifth and fourteenth amendments. \textit{Id.} at 781.

\textsuperscript{43} See note 39 supra.

\textsuperscript{44} See Comment, supra note 41, at 179-80.
guarantee to a fair trial. The *Bruton* opinion is couched in such due process language. It is not inconceivable that the standards used in assessing the degree of prejudice to a particular defendant when limiting instructions are ineffective are those same notions of fairness and due process. The constitutional right then placed in jeopardy might ultimately be due process of law.

*Gilbert Newman*

CORPORATIONS — INSIDER SHARE TRADING — TRADING WITHOUT DISCLOSURE OF PROSPECTIVE MINE HELD TO VIOLATE RULE 10b-5.

*SEC v. Texas Gulf Sulphur Co.* (2d Cir. 1968)

On November 8, 1963, Texas Gulf Sulphur Co. (TGS) began mineral drilling operations for a geophysical survey on a segment of its land near Timmins, Ontario. Four days later, the initial drilling revealed such potential that it was thought desirable to acquire more land in the area. To facilitate such an acquisition, Stephens, TGS president, ordered that the results and existence of the drilling be kept confidential, even from the company's other directors and officials. Drilling on the site was discontinued until March 31, 1964. During the period of discontinuance, the 11 individual defendants, who were officers, directors, and employees of TGS, were charged with having traded in stocks and stock options on the basis of inside undisclosed information in violation of section 10(b) of the Securities Exchange Act of 1934,¹ and rule 10b–5² promulgated thereunder.

Drilling at several other sites was commenced during the first week of April 1964. Meanwhile, rumors began to circulate that TGS had made

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¹ 15 U.S.C. § 78(j) (1963) reads in part:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

² SEC Rule 10b-5, 17 C.F.R. § 240.10b–5 (1968) provides:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange —

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
a rich strike. On Sunday, April 12, TGS issued a press release from Canada claiming that drilling to that date had been inconclusive and that rumors of a rich strike were without any basis in fact. This release appeared in United States newspapers the next morning. At 9:40 a.m. on April 16, TGS announced a strike of 25 million tons. Between the first release on April 12 (the denial) and the second on April 16 (the confirmation), only two defendants, Clayton and Crawford, were engaged in security trading. Another defendant, Coates, left the TGS press conference of April 16 while it was in progress to telephone his broker. With these exceptions, all purchases made by defendants and their “tippees” were made before April 9.  

The Securities and Exchange Commission brought an action in the District Court for the Southern District of New York citing the following violations of rule 10b-5: 1) the purchase of stock on the basis of undisclosed inside information by nine of the 11 individual defendants; 2) the divulging of inside information to “tippees” by two of the individual defendants; 3) the purchasing of stock options by five of the defendants from members of the board of directors of TGS who were unaware of the new strike; and 4) the issuance of a false, misleading, and deceptive press release by TGS, the corporate defendant. The SEC requested the following relief: 1) that individual defendants be restrained from purchasing or selling stock on the basis of unavailable information; 2) that offers of rescission be made by individual defendants to each person from whom they purchased shares; 3) that the defendants be required to offer restitution to the persons who sold to the insiders “tippees”; 4) that stock options be cancelled and any profits be returned to the company; and 5) that the company be enjoined from issuing any materially false, misleading, inadequate, or inaccurate press releases.

The district court found that Clayton and Crawford violated rule 10b-5, but dismissed the complaint against TGS and the other defendants.  

Clayton and Crawford appealed the decision rendered against them, and the SEC appealed the dismissal as to the other defendants. The Court  

3. The district court selected April 9 as a critical date since testimony by defendants' experts established that the drilling of three holes prior to 7 p.m. on April 9 did not conclusively determine that TGS had struck a valuable mine. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 282 (S.D.N.Y. 1966).

of Appeals for the Second Circuit affirmed the decision as to Clayton and Crawford but reversed the dismissal as to all but one individual defendant, *holding* that the individual defendants violated rule 10b–5 in their dealings and *remanding* as to whether the corporate defendant’s press release was misleading to the reasonable investor, and if found to be misleading, whether the court in its discretion should issue the injunction which the SEC seeks. *SEC v. Texas Gulf Sulphur Co.*, No. 30882 (2d Cir., Aug. 13, 1968), *petition for cert. filed*, 37 U.S.L.W. 3095 (U.S. Sept. 17, 1968) (No. 533).

After the market crash of 1929, the federal government commenced active participation in the regulation of security transactions. The Securities Act of 19335 was enacted to provide the investor with full disclosure concerning new stock issues,6 and the Securities Exchange Act of 19347 was designed primarily to protect the investor against manipulation and unfair practices and to insure fairness in corporate share trading.8

Basic to the implementation of these purposes is the imposition, pursuant to rule 10b–5, of a duty on insiders to disclose material facts before trading in their company’s securities. This duty to disclose was explained in *In re Cady, Roberts & Co.* as follows:

> Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.9

When one has the obligation to disclose material facts, rule 10b–5 has been interpreted to protect both buyers and sellers of securities,10 to apply to transactions on exchanges as well as face-to-face,11 and to impose liability for trading in total silence.12

The instant case is significant in that it explores the outer boundaries of the impact of rule 10b–5. To at least one commentator,13 the district court’s disposition of the case enlarged the scope of the rule. If this be the case, the court of appeals’ reversal of the dismissal of nine of the individual defendants and its remand of the corporate defendant represents a tenfold expansion. Although the conflicting conclusions reached by the appellate and district courts result partly from conflicting interpretations of the

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10. *E.g.*, Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Matheson v. Ambrust, 284 F.2d 670 (9th Cir. 1960); Dauphin Corp. v. Redwall Corp., 201 F. Supp. 466 (D. Del. 1962).
firms, the major disagreement is in the differing legal standards to be applied to those facts.

In any controversy involving rule 10b-5 and the problem of insider share trading, five major issues are pivotal: 1) who are insiders; 2) what type of information is material within the ambit of the rule; 3) when may insiders begin to trade after public disclosure; 4) what is the impact of the "in connection with" requirement of the rule on the corporate defendants; and 5) what remedies are available.

The appellate court's reversal of the district court was not based on differing definitions of an insider. The generally accepted standard, expounded in In re Cady, Roberts & Co., focuses on the individual's access to information and his relatively unfair position in the market. This standard was adopted unqualifiedly by both courts.

The major point of disagreement, however, involved the standard applied to determine the materiality of the facts allegedly undisclosed. Rule 10b-5 dictates that in certain situations, which are essentially extraordinary and which, if disclosed to the public, are reasonably certain to have a substantial effect on the market price of the security, a duty arises either to disclose the basic facts or to refrain from insider share trading. This duty arises only with respect to material facts; one's own analysis of those freely available facts may be kept confidential during trading without a violation. In the instant case, the controversy between the district and appellate courts centers on whether knowledge of the existence and analysis of the first core drilling at Timmins is a material fact within the meaning of rule 10b-5.

In expressing the basic standard for materiality, the appellate court, quoting List v. Fashion Park, Inc., stated: "The basic test of materiality . . . is whether a reasonable man would attach importance . . . [to the undisclosed facts] in determining his choice of action in the transaction in question." The court explained that this test of materiality would include any basic fact or set of facts which might affect the value of the corporation's securities. The court then proposed a balance-

17. See Comment, The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors, 59 YALE L.J. 1120, 1148 (1950), where the author explains: "Even though a shrewd guess by an insider is often worth fifty accounting statements, it would be highly unfair to make him publicize his guess and then hold him responsible if it turns out to be wrong."
ing test to determine the materiality of facts. This test would compare both the probability of the occurrence of an event and the magnitude of the event, if it does occur, with the company's total activities. Applying this balancing test to the instant case, the appellate court found that knowledge of the first core drilling was a material fact. While there was testimony that the results of a single core do not prove the existence of a mine and that there was no way of knowing the true extent of the mine, the possible magnitude of the strike if the first core proved representative of a large area was found to be controlling. The appellate court further stated that an important index of the relative probability and magnitude is the reaction of those who knew about the first core and the importance they attached to it, and that the amount of stock and "calls" purchased by the individual defendants and the timing of such purchases compelled the inference that the insiders were highly influenced. The court concluded that disclosure of the drilling might have affected the price of TGS stock and would have been an important fact to a reasonable, if speculative, investor in deciding whether to buy and sell and, thus, was a material fact.

In a lengthy dissent, Circuit Judge Moore argued that the appellate court, by disregarding the uncontradicted findings of fact by the trial court, violated rule 52(a) of the Federal Rules of Civil Procedure. The dissent insisted that since expert testimony played a key role in the trial court and since it could not be said that the district court's findings of fact were clearly erroneous, the appellate court should not have set aside the trial court's finding that until 7 p.m. on April 9 the drill results did not provide material information. This disagreement between the dissent and majority appears to be largely a dispute over what is an ultimate fact, reviewable by the appellate court, and what is a basic fact.

The dissent goes on to bolster the district court's finding by arguing that disclosure of the results of the first drilling not only were not material but would have been illegal under the Commission's own rules. With regard to the disclosure of claims of strikes, SEC standards provide that no claim shall be made as to the existence of a body of ore until found to be proven or proveable ore defined as so extensively sampled that risk of failure is reduced to a minimum. This argument, however, overlooks the fact that the insiders need not have disclosed that a body of ore existed but merely have revealed the facts which they knew — the existence of

21. Id. at 3609.
22. Id. at 3612.
23. Id. at 3610-14.
24. Fed. R. Civ. P. 52(a) states in part: "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses."
26. Id. at 3664.
27. Id. at 3609 n.11.
28. Id. at 3657-58.
29. CCH Fed. Sec. Lit. Rev. ¶7322, 8A (b) (c).
one core and its analysis. This would involve no speculation by the insiders and would not be construed as a premature announcement.

As the appellate court noted, however, its primary disagreement with the district court did not concern findings of fact, but rather the appropriate legal standard applicable to them.50 The district court took the following approach to the question of materiality: "But the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight."51 Viewing the test in this way the conclusion of the district court was that the results of the drilling were "too remote" to be material,52 that in order for the results to be deemed material, it would have to be "reasonably certain [that] if disclosed, [the information] would have had a substantial impact on the market price of TGS stock."33

The difference between the two standards seems to be one of inference. The appellate court's test suggests an inference that undisclosed information is material and all that need be shown is that its disclosure might affect the market value and would have been an important fact to a reasonable, if speculative, investor. On the other hand, the district court's test raises an inference that the information is not material and requires reasonable certainty of a substantial effect before information is found to be material.

In deciding which test best reflects the aims and goals of rule 10b–5, it must be remembered that basic to the rule is the concept of fairness. The purpose of rule 10b–5 is to ensure that investors have equal access to the rewards of participating in securities transactions; that they have equal risks; and that they stand on equal footing.54 From this viewpoint it is clear why the court of appeals held that all transactions in TGS stock by those apprised of the results of the first core violated rule 10b–5 — the inside investors had nothing to lose and took no risks. If the mine proved to be worthless, the value of their stock would not be affected since the public's expectations were never raised and could not be dashed.55 On the other hand, they were assured of a high profit as soon as the news of the strike was released.

Once the insider deems the information material and makes a full disclosure, the question remains as to how soon after public disclosure he may act. In the instant case, the announcement of a significant strike was made in Canada on April 16 at 9:40 a.m., at 10 a.m. in the United

32. Id. at 283.
33. Id. at 282 (emphasis added).
35. Id. at 3614.
36. Id.
States, appeared over Merrill Lynch wires at 10:29 a.m., and over Dow Jones at 10:54 a.m. Crawford telephoned his orders to his Midwestern broker about midnight on April 15 and again at 8:30 a.m. on April 16 with instructions to buy that morning. Coates left the press conference and placed his orders no later than 10:20 a.m. The court of appeals affirmed the district court’s decision which held that both defendants violated rule 10b–5 in “beating the news.” The court of appeals stated the test for determining when, after disclosure is made, insiders may legally trade:

Before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public. . . . The reading of a news release . . . is merely the first step in the process of dissemination required for compliance with the regulatory objective of providing all investors with an equal opportunity to make informed investment judgments.

In interpreting the meaning of an informed investment judgment, the court stated that in cases where the facts are not readily translatable into investment action, the insiders may not trade immediately upon disclosure and thereby take advantage of their prior opportunity to evaluate the information. This standard would seem to be an invitation to ambiguity. Would the application of this standard require the length of the waiting period to vary with the complexity of the information? What if some of the other investors do not have the experts on hand necessary to translate such information into action? Would the insiders have to wait until such experts are obtained? Must the investors who have experts readily available also refrain from investing? The court provides no measure by which insiders can estimate what is a reasonable period under the circumstances. It is apparent, as the appellate court and at least one commentator have recognized, that an arbitrary standard is required (e.g., 24 hours after release) if there is to be any predictability of results in future litigation and if an insider is to know in advance whether his transaction is in violation of the law. However, the establishment of such a standard is more in tune with legislative or administrative action than judicial decision.

The SEC also sought relief in the form of a permanent injunction against the corporate defendant, TGS, restraining it from issuing any further materially false and misleading publicly distributed informative items. The district court refused to grant the injunction on the ground that there was no showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders.

37. Id. at 3617–18.
38. Id.
39. Id. at 3618 n.18.
40. Id.
[therefore] the issuance of the press release did not constitute a violation of Section 10(b) or Rule 10b–5 since it was not issued "in connection with" the purchase or sale of any security.\textsuperscript{44}

The district court interpreted the phrase to require that TGS derive some direct benefit from the issuance of the press release or that the individuals who prepared it use it to their personal advantage or that its issuance produce or be intended to produce an unusual market reaction.\textsuperscript{45}

The court of appeals concluded that the legislative history of section 10(b) and of rule 10b–5 does not support the limited construction of the "in connection with" phrase applied by the trial court.\textsuperscript{46} Focusing primarily on the protection of the public investor, the court of appeals reasoned that rule 10b–5 is violated whenever statements, reasonably calculated to influence the investing public, are made, if such statements are misleading or so incomplete as to mislead \textit{regardless of the existence of ulterior motives}.\textsuperscript{47} The issue was remanded to the district court for a determination consistent with the appellate court's standard of whether the press release was misleading.\textsuperscript{48} This broader interpretation of the "in connection with" phrase of rule 10b–5 is a recognition of the fact that the public suffers a loss due to a misleading statement regardless of whether the publisher trades in the market himself. It is the better standard simply because it is more realistic.

The fifth major issue of a 10b–5 action, and the problem left largely unanswered in the TGS opinion, is that of the remedies available to injured investors. The appellate court, pursuant to a stipulation by the parties that the issue of remedies be deferred pending a final determination of whether any defendants violated rule 10b–5,\textsuperscript{49} remanded the entire issue of remedies to the trial court.\textsuperscript{50} The difficulty presented by the remedy issue lies in the formulation of appropriate relief since the damage caused to the public cannot easily be repaired. The injunction remedy against the individual and corporate defendants will serve to punish violators and deter further violations. The cancellation of stock options and return of profits to the corporation alleviates, at least to some extent, the corporation's losses. However, the investing public, goes virtually without a remedy.

\textsuperscript{45} \textit{Id.} at 294.
\textsuperscript{46} SEC v. Texas Gulf Sulphur Co., No. 30882, 3629 (2d Cir., Aug. 13, 1968), \textit{petition for cert. filed, 37 U.S.L.W. 3095} (U.S. Sept. 17, 1968) (No. 533). It is interesting to note, in his dissent Circuit Judge Moore examines the same legislative history and finds that "[t]he legislative history clearly reveals that . . . the 'connection' between the complained of conduct and the securities transaction must be a closer one than the majority now sanctions." \textit{Id.} at 3679.
\textsuperscript{47} \textit{Id.} at 3634.
\textsuperscript{48} The court noted that a good faith diligent effort to publish the whole truth would be a valid defense. \textit{Id.}
\textsuperscript{49} \textit{Id.} at 3590 n.1.
\textsuperscript{50} This is the first case in which the Commission has requested affirmative relief to investors. \textit{See} Kennedy and Wander, \textit{Texas Gulf Sulphur: A Most Unusual Case}, \textit{20 Bus. Law.} 1057, 1073 (1965).
The complexity of the market and the diverse and immeasurable effects of any manipulative or deceptive device add greatly to the problem. The market being much like a closed system, when one profits wrongfully, it may be inferred that it is at the expense of other investors. But unlike face-to-face transactions where the other party is known, a transaction on an exchange is one with an anonymous "public-at-large." Assuming the damage could be calculated, the perplexing question remains as to which investors should be the recipients of any rescission or restitution.

From one point of view, it can be argued that no single investor actually suffered by an insider's trading. The insider purchased at market value and the seller was willing to sell at that price without any knowledge that the insider even existed. It can be further argued that if the insider had decided to refrain from trading pursuant to rule 10b-5, the seller nonetheless would have offered his stock for sale at the market price and probably would have sold it. Hence, the seller would have received the same price regardless of whether the insider was trading. This argument would overlook, however, the fact that once an insider elects to trade on the basis of inside material information, he is subject to rule 10b-5. He is free to elect either to trade or not, and if he chooses to trade he is under a duty to disclose material facts. If he makes an adequate disclosure, the seller may change his mind, either deciding not to sell or insisting on a higher price. Hence, it is both the insider's presence in the market coupled with his refusal to disclose which is the proximate cause of the seller's loss.

Although this chain of causation affixes liability, who should recover? It is possible to gather the names of all those trading in the stock during the violations and then require the violator to disgorge his profits, which are then divided among the innocent investors according to the number of shares they had purchased. However, the pitfall of this remedy is obvious — the returned profits would be spread so thinly that no single investor would begin to recover his loss.

In conclusion, since the instant decision has extended the scope of rule 10b-5 by expanding the concept of materiality and by applying an extremely liberal interpretation to the "in connection with" requirement, and since, as a result, the boundaries of liability have become even hazier, the courts will be faced with a deluge of similar cases. This will in turn force the courts to distinguish and, perhaps, limit TGS, to define precisely the predicates of liability, and to offer workable guidelines for remedies.

David S. Markson

51. The SEC brought an action against Merrill, Lynch, Pierce, Fenner & Smith, Inc., the world's largest brokerage house, charging a 10b-5 violation involving tipoffs to favored customers to sell shares of Douglas Aircraft Co. on the basis of inside information that Douglas' earnings were going to fall. Time, Sept. 6, 1968, at 83-84; Wall St. J., Aug. 28, 1968, at 3, col. 1.

A Penn Central stockholder has filed suit in District Court for the Eastern District of Pennsylvania charging Butcher & Sherrerd, a Philadelphia brokerage firm, with acting on inside information in selling Penn Central shares when prospects declined. Phila. Evening Bull., Sept. 16, 1968, at 24, col. 5.
HOUSING AND URBAN RENEWAL — STANDING — NEGRO AND PUERTO RICAN CITIZENS DISPLACED BY URBAN RENEWAL PROGRAM HAVE STANDING TO ENFORCE THE RELOCATION REQUIREMENTS OF SECTION 105(c) OF THE HOUSING ACT AND TO CLAIM A DENIAL OF EQUAL PROTECTION OF THE LAW IN THE IMPLEMENTATION OF THE RELOCATION PROGRAM.

Norwalk CORE v. Norwalk Redevelopment Agency
(2d Cir. 1968)

Plaintiffs brought a class action in the United States District Court for the District of Connecticut to enjoin certain local and federal officials, as well as private developers, from proceeding with the construction of a moderate income housing project which was part of an urban renewal program in Norwalk, Connecticut. The Norwalk Redevelopment Agency entered into a Loan and Capital Grant Contract with the Housing and Home Finance Agency (HHFA), now the Department of Housing and Urban Development (HUD), under the Housing Acts of 1949 and 1954. Section 105(c) of the Act conditions the award of federal funds on the existence of a community program to relocate displaced site families according to the standards set forth in that section.

The complaint alleged that in planning and implementing the program, the Agency did not assure, as required by the contract, adequate relocation for Negro and Puerto Rican displacees to the same extent that it did for whites, that the Agency knew there was rampant discrimination in the private housing market, and while white displacees could obtain hous-

1. Norwalk, Connecticut chapter of the Congress of Racial Equality, two non-profit tenants' associations comprised of low income Negroes and Puerto Ricans, one representing former residents of the project area, and the other representing those living outside the project area, and eight individuals representing four classes: (1) those still occupying homes within the project area; (2) those whose homes in the project area were demolished and who now occupy "overcrowded" rental units outside the project area but within the city of Norwalk; (3) those whose homes in the project area were demolished and who now occupy rental units "at excessive rentals" outside the project area but within the city of Norwalk; and (4) those who formerly lived in Norwalk, but "by virtue of the acts of defendants" now occupy rental units outside of the city.


3. 42 U.S.C. § 1455(c) (Supp. 1967) provides in relevant part:

Contracts for loans or capital grants shall be made only with a duly authorized local public agency and shall require that —

(c) (1) There shall be a feasible method for the temporary relocation of individuals and families displaced from the urban renewal area, and there are or are being provided, in the urban renewal area or in other areas not generally less desirable in regard to public utilities and public and commercial facilities and at rents or prices within the financial means of the individuals and families displaced from the urban renewal area, decent, safe, and sanitary dwellings equal in number to the number of and available to such displaced individuals and families and reasonably accessible to their places of employment.

This section's coverage was extended to displaced individuals by the Housing and Urban Development Act of 1965, but that extension does not apply to this project. Housing and Urban Development Act of 1965, Pub. L. No. 89-117, § 305(c), 79 Stat. 426. The plaintiffs in this case all represented displaced families.
ing, Negroes and Puerto Ricans were forced either to pay exorbitant rentals or leave the city. The plaintiffs made two claims based upon the foregoing allegations: (1) that they had been denied equal protection of the law guaranteed by the fourteenth amendment and (2) that the defendant had acted in violation of section 105(c) of the Housing Act.

The district court dismissed the complaint on the ground that this was not a proper class action and, even assuming it was, plaintiffs had no standing under the Housing Act to challenge the planning or implementation of an urban renewal project, and that the mere allegation of civil rights violations will not confer standing to raise a constitutional argument. The Court of Appeals for the Second Circuit reversed and remanded, holding that the complaint stated both constitutional and statutory claims on which relief could be granted, that the individual plaintiffs had standing to make the claims, and that the action was properly brought as a class action. Norwalk CORE v. Norwalk Redevelopment Agency, 395 F.2d 920 (2d Cir. 1968).

In the only three cases which have heretofore dealt with displacee standing under section 105(c), the federal courts, under the rubric of "lack of standing," have effectively barred private citizens from challenging the relocation plans of an urban renewal program. Two reasons have been espoused by those courts for this denial. In Green St. Ass'n v. Daley, the most recent case prior to Norwalk to deal with this issue, the Seventh Circuit, relying on its prior decision in Harrison-Halsted Community Group, Inc. v. HHFA, denied standing on the ground that the provisions of the Housing Act did not confer "private legal rights" on displacees. The Ninth Circuit, on the other hand, in Johnson v. Redevelopment Agency based its denial, at least partially, on the theory that Congress did not intend section 105(c) "to give a right of action to those not a party to the contract between the Redevelopment Agency and the United States."  

In none of these cases was the issue of displacee standing with regard to a constitutional claim of deprivation of equal protection of the law decided. Although the complaint in Green St. raised this issue, the court

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6. The district court's holding that this was not a proper class action under Fed. R. Civ. P. 23 was reversed as to the individual plaintiffs but not decided with respect to the association plaintiffs. The class action aspect of this case will not be discussed in this Note.
8. 373 F.2d 1 (7th Cir.), cert. denied, 387 U.S. 932 (1967).
denied standing under section 105(c) and did not consider the constitutional argument. Harrison-Halsted did not involve an equal protection claim, and in Johnson, while constitutional claims were alleged initially, on appeal the issues were narrowed to whether the defendant was carrying out a feasible plan of relocation as required by section 105(c). In Norwalk, a federal court of appeals, for the first time, granted standing to displacees to raise a constitutional claim of denial of equal protection of the law in the relocation plans of an urban renewal program.

In order to comply with the constitutional restriction on federal court jurisdiction that legal issues be presented within the framework of a "case" or "controversy," the courts must find that the plaintiff has standing to sue and that the issue to be resolved is a justiciable one. In determining the issue of standing, which focuses on the status of a party, the courts have held that a plaintiff must have a personal stake in the outcome of the controversy before they will entertain his suit. Moreover, even though a party may have a personal stake, if the right he is attempting to assert is not one recognized by the courts, he will be denied standing. The Norwalk court, applying these traditional criteria, found little difficulty in holding that the plaintiffs had established standing to raise their equal protection claim. The court reasoned that since plaintiffs' houses were razed without provision for adequate relocation facilities, their stake in the outcome of the case was immediate and personal, and further concluded that the right which they alleged had been violated, the right not to be subject to racial discrimination in government programs, was within the protection of the courts.

With respect to the issue of whether the plaintiffs had presented a justiciable question, the court similarly had little difficulty finding in their favor. The concept of justiciability, as distinguished from the concept of standing, centers on whether the question presented is one

13. See note 17 infra.
15. For example, it is well established that injury through economic competition is generally not a sufficient basis for standing to sue. Alabama Power Co. v. Ickes, 302 U.S. 464 (1938); Berry v. HHFA, 340 F.2d 939 (2d Cir. 1965); Pennsylvania R.R. v. Dillon, 335 F.2d 292 (D.C. Cir.), cert. denied, 379 U.S. 945 (1964); Pittsburgh Hotels Ass'n v. Urban Redevelopment Authority, 309 F.2d 186 (3d Cir. 1962), cert. denied, 273 U.S. 916 (1963); Taft Hotel Corp. v. HHFA, 262 F.2d 307 (2d Cir. 1958), cert. denied, 359 U.S. 967 (1959); Allied-City Wide v. Cole, 230 F.2d 827 (D.C. Cir. 1956); Kansas City Power & Light Co. v. McKay, 225 F.2d 924 (D.C. Cir.), cert. denied, 350 U.S. 884 (1955). But cf. pp. 152-53 infra where one may have standing based on competitive interest when it is provided by statute. FCC v. Sanders Bros. Radio Station, 309 U.S. 470 (1940).
17. The Supreme Court in Flast v. Cohen, 392 U.S. 83 (1968) recognized that the distinction has not always appeared with clarity in its prior cases. The Court defined the concepts as follows: "[W]hen standing is placed in issue in a case, the question is whether the person whose standing is challenged is a proper party to request an adjudication of a particular issue and not whether the issue itself is justiciable." Id. at 99-100.
the courts can or should attempt to adjudicate.\textsuperscript{18} If the court were confronted with a challenge to the basic validity of an urban renewal plan,\textsuperscript{19} it might then be faced with a nonjusticiable political question.\textsuperscript{20} In \textit{Norwalk}, however, the court narrowly framed the issue so that the plaintiffs' constitutional claim was that the standard for relocation was being met less sufficiently for Negroes and Puerto Ricans than it was for whites. By viewing the plaintiffs' complaint in this way, the court was confronted with a justiciable question.

In resolving whether the plaintiffs had standing to raise their statutory claims, the \textit{Norwalk} court relied on the recent Supreme Court case of \textit{Abbott Laboratories v. Gardner}\textsuperscript{21} and on the legislative history of the Act.\textsuperscript{22} The court reasoned that Congress intended to protect the specific interests of displacees when it enacted the relocation provision, and that since there was no persuasive reason to believe it intended to cut off judicial review,\textsuperscript{23} plaintiffs had standing.

Case law has established a presumption of a right to judicial review in persons whose interests are "acutely and immediately" affected by administrative action.\textsuperscript{24} The Supreme Court has consistently held that standing to challenge administrative action exists where a statute is enacted to protect a competitive interest and where the party sharing that interest alleges its disregard by the agency.\textsuperscript{25} Since the courts have


\textsuperscript{19} In \textit{Green St.}, in addition to challenging the relocation plan, the plaintiffs sought to enjoin acquisitions which were part of the urban renewal plan. This, in effect, was a challenge to the whole program. The Seventh Circuit dismissed the complaint on the ground that any taking of land under the eminent domain power which is ostensibly for a public purpose, even though violations of federal rights are claimed, is a matter for state courts except in the most unusual circumstances. 372 F.2d at 7. \textit{But see} 81 HARV. L. REV. 1568 (1968). However, as the \textit{Norwalk} court pointed out, the Seventh Circuit's discussion of the issue "implies that it harbored some doubt as to the justiciability of the issues . . . ." 395 F.2d at 928.

\textsuperscript{20} The \textit{Norwalk} court noted that an overall challenge of this type was considered on the merits in Nashville I-40 Steering Comm. v. Ellington, 387 F.2d 179 (6th Cir. 1967), \textit{cert. denied}, 390 U.S. 921 (1968).

\textsuperscript{21} 387 U.S. 136 (1967). Mr. Justice Harlan stated: "[J]udicial review of a final agency action by an aggrieved person will not be cut off unless there is persuasive reason to believe that such was the purpose of Congress." \textit{Id.} at 140.

\textsuperscript{22} S. REP. No. 84, 81st Cong., 1st Sess. 14 (1949). It is stated therein: The bill sets up adequate safeguards against any undue hardship resulting from the undertaking of slum clearance under current conditions. It requires, first, that no slum-clearance project shall be undertaken by a local public agency unless there is a feasible means for the temporary relocation of the families to be displaced, and unless adequate permanent housing is available or is being made available to them.

\textsuperscript{23} It may be argued that since Congress has explicitly given HUD authority to make moving expense determinations nonreviewable, Housing Act of 1949, § 114(d), 42 U.S.C. § 1465(d) (Supp. 1967), if it intended to make the 105(c) finding also nonreviewable, it would have written a similar provision into the Act. \textit{See Comment, Judicial Review of Displacee Relocation in Urban Renewal, 77 YALE L.J. 960, 972 n.28 (1968).}

\textsuperscript{24} \textit{See L. JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION} 336–63 (1965). \textit{See also} 4 K. DAVIS, ADMINISTRATIVE LAW § 28.21 (Supp. 1965).

recognized that a competitive interest when protected by statute is sufficient to support standing to challenge an administrative action, the interest of displacees in decent, safe, and sanitary relocation housing would seem to be no less compelling. Although it could be argued that while Congress enacted section 105(c) to protect displacees, it intended to entrust HUD with the sole responsibility of enforcing their rights, the well settled rule which establishes a presumption of judicial review would seem to rebut this argument.

Moreover, the cases of Gart v. Cole and Merge v. Sharott provide precedents which justify the court's grant of standing under the Housing Act. In Gart standing was granted to plaintiffs to contest the procedures adopted by the HHFA Administrator under section 101(c) of the same Housing Act and in Merge, the court held that displaced businessmen had standing to sue to recover relocation compensation under section 114 of the Act. The fact that members of the business community have standing in the federal courts under the Housing Act to protect their financial interest when threatened by relocation is strong support for the court's holding that Negro and Puerto Rican displacees have standing under the same Act to protect their right to a decent home.

The court's decision is further supported by the legislative history of the Housing Act and the continued strengthening of its relocation provision which seem to clearly import that Congress intended to protect the specific interests of the displacees. In addition, the congressional declaration of national housing policy explicitly states that the central goal of the Housing Act is "a decent home and a suitable living environment for every American family," while section 105(c) specifically guarantees "decent, safe, and sanitary" rehousing to displaced families. These

27. 341 F.2d 989 (3d Cir. 1965).
28. 42 U.S.C. § 1451(c) (1964). This section was amended and today is a non-delegable function of the Assistant Secretary for Renewal and Housing Assistance. 31 Fed. Reg. 8964-65 (1966). The plaintiffs in Gart had alleged that the HHFA administrator improperly delegated his duty to review the feasibility of the project's relocation provisions. 263 F.2d at 251.
29. 341 F.2d at 994. 42 U.S.C. § 1465(b) (1964), provides in relevant part: "A local public agency may pay to any displaced business concern or nonprofit organization . . . its reasonable and necessary moving expenses . . . ."
30. See note 22 supra.
31. The 1964 amendments broadened the coverage to include individuals as well as families and required that each community establish a special relocation assistance program to minimize the hardships of displacement. Housing Act of 1964, Pub. L. No. 88-560, § 305, 78 Stat. 786. See also Note, Protecting the Standing of Renewal Site Families to Seek Review of Community Relocation Planning, 73 YALE L.J. 1080, 1081 (1964). In 1965, the requirements of careful planning were further elaborated and as a condition for further assistance, reassurances that relocation housing would be available were required from localities carrying out urban renewal programs. 42 U.S.C. § 1455(c)(2) (Supp. I, 1965). In 1966, an amendment that the redevelopment of the urban renewal area (unless such redevelopment is for predominantly non-residential uses) will provide for a substantial number of standard housing of low and moderate cost to serve poor and disadvantaged people was enacted. 42 U.S.C. § 1455(f) (Supp. 1967).
espoused goals seem to dictate that the courts should grant standing to displacees so that the rights afforded them by the Act may be effectuated.

It is submitted that the three cases relied on by the district court to deny standing were wrongly decided to the extent that they are inconsistent with the instant decision. While it has been suggested that the Johnson case need not be read to preclude judicial review of agency action under section 105(c), there seems to be no support for its statement that Congress did not intend to give displacees "a right of action." The Green St. court relied on Harrison-Halsted as precedent to deny standing under section 105(c). It would appear that reliance on the former case was misplaced, since the main focus in Harrison-Halsted was on the particular plaintiffs who made the challenge rather than on the availability of review under the Housing Act. The plaintiffs had objected to a revised urban renewal plan, claiming they would suffer economic injury as a result of the revision. The Harrison-Halsted court held that it did not appear that any of the plaintiffs' "private legal rights" had been violated. This holding, that injury through economic competition is not generally a sufficient basis for standing to sue, is a well established proposition. But, as the Norwalk court pointed out, "none of those cases [relied on by Harrison-Halsted] supports a holding that displacees have no standing to seek judicial review of agency action under section 105(c)."

Since some aspects of urban renewal programs will be subject to judicial review, an important ramification of the instant decision will be a more stringent enforcement of section 105(c). This effect may be limited, however, because courts may be hesitant to become involved in an area not within their traditional functions. The defendants in Norwalk had contended that plaintiffs' claim was nonjusticiable, as it would involve the courts in overall urban renewal planning and inevitably in the resolution of questions which are ultimately political. The Norwalk court recognized that courts, due to the political implications, have been generally reluctant to interfere with urban renewal planning and conceded the necessity of discretionary decisionmaking in this area. However, the court also firmly stated that courts should not abdicate their responsibility to

34. Cases cited note 7 supra. It should be noted that since the Housing Act contains no review provisions, the right to review in Green St. and Harrison-Halsted was claimed under section 10 of the Administrative Procedure Act (APA), now chapter 7 of title 5 of the U.S. Code. Administrative Procedure Act § 10, 5 U.S.C. §§ 701-06 (Supp. II, 1965-66). It has been suggested that a court granting standing under section 105(c) of the Housing Act would conform to the purpose of APA section 10 which is said to codify the presumption in favor of judicial review. See Comment, Judicial Review of Displacee Relocation in Urban Renewal, 77 YALE L.J. 966, 973 (1968).

35. See Note, Protecting the Standing of Renewal Site Families to Seek Review of Community Relocation Planning, 73 YALE L.J. 1080 (1964).


37. See cases cited note 15 supra.

38. 395 F.2d at 935.
protect site displacees from infringement of their constitutional rights. Thus the court advocated a middle position by stating:

Case-by-case inquiry is necessary, with due regard for the need for judicially discoverable and manageable standards for resolving problems to be undertaken, and with recognition of the role played by the coordinate branches of the Federal Government in the planning and implementation of urban renewal.40

To foreclose access to federal courts when citizens claim a denial of constitutional rights simply because the area in which defendants have acted is normally not subject to judicial review would be inconsistent with a long line of decisions.41 In view of the court’s narrow holding, which limits review to insuring that the standard for relocation is met equally for all citizens, white as well as nonwhite, the instant decision, while affording citizens a means of protecting constitutionally guaranteed rights, need not involve the courts in the political question of overall urban renewal planning.42

The Norwalk decision has also raised a question as to the form of relief that should be granted if the plaintiffs have in fact been denied equal protection or if their rights under section 105(c) of the Act have been violated. While the Norwalk court was not willing to speculate on the appropriate remedy, it did rule out the affirmative form of relief requested by plaintiffs — an order requiring construction of low-income housing under court supervision — as it would involve the courts in areas foreign to their experience and competence. In addition the court was careful to point out that the standard for relocation is not for the courts to establish; the standard has been set by Congress, and HUD was entrusted with the primary responsibility of enforcing it. If, as was suggested by the Norwalk court, the courts required proof that the relocation standards were being met as adequately for nonwhite as they were for whites before permitting the project to proceed, they would be applying the appropriate form of relief in cases of this kind. However, it is possible that other courts, faced with the task of approving complex programs of relocation as part of the remedy, might classify the issue as nonjusticiable.

A further consequence of Norwalk may be a temporary curtailment of urban renewal activities because of the availability of limited judicial review of urban redevelopment and because as a possible remedy the courts may require proof of adequate relocation before allowing the program to proceed. It would appear, however, that such temporary curtailment is justified if it is necessary to insure displacees of adequate relocation building. As the Advisory Committee on Intergovernmental Relations concluded

40. 395 F.2d at 929.
42. The existence of judicial review inevitably increases the potential for “harassing” suits which could unnecessarily interfere with urban renewal programs. Most of these suits, however, could be disposed of by summary judgment. Fed. R. Civ. P. 12(c), 56.
after a thorough study of the relocation problem: "[T]he Commission believes the goal of providing standard housing for all is of such pre-eminent importance that its availability should be assured even if it means a delay in a federally aided project." 43

It is submitted that no distortion of existing law is necessary to establish that plaintiffs have standing, both to raise their constitutional claim and to enforce the relocation provisions under section 105(c) of the Housing Act. A court which refused to intervene in the administration of section 105(c) would be abdicating its traditional responsibility to insure that administrative action is confined within the bounds of agency discretion and authority. Moreover, the court's decision is a step towards insuring the implementation of a congressional edict — decent, safe, and sanitary dwellings for site displaces. The "threat" of judicial review of its activities should insure that HUD, which has the expertise to initially ascertain the adequacy of local relocation plans, will properly protect the interest of site families.

Andre G. Sassoon

LABOR LAW — LOCKOUTS — NATIONAL LABOR RELATIONS BOARD APPROVES OFFENSIVE USE OF LOCKOUT BY SINGLE EMPLOYER IN PRE-IMPASSÉ SITUATION.

Darling & Co. (N.L.R.B. 1968)

The respondent is a manufacturer, seller, and distributor of fertilizers, and makes 70 percent of its annual shipments between March and May. The company's production employees were represented in negotiations for a new contract by the International Chemical Workers Union, Local 127. Although the expiration date of the then effective contract was December 1, 1965, the employees continued working beyond this date. In the course of negotiations, the union received a copy of a medical plan proposed by the company, and the union representatives requested a 7- to 10-day analysis period. During the analysis period, respondent, citing an impasse in negotiations, locked out the production employees.

At the hearing before the trial examiner, the company asserted two different reasons for the lockout: (1) to apply economic pressure on employees to encourage them to accede to company proposals and (2) to avert the repetition of a strike which occurred during its 1962 shipping season. The trial examiner concluded that the absence of an impasse ren-


1. While not statutorily defined, a lockout is a temporary layoff of some or all employees when work is available to apply economic pressure in order to gain accedence to company proposals. American Ship Bldg. Co. v. NLRB, 380 U.S. 300, 301 (1965).
ordered the Supreme Court's decision in *American Ship Bldg. Co. v. NLRB* inapplicable and, therefore, the prior decisions of the National Labor Relations Board, which held that absent special circumstances an employer may not lockout in support of his bargaining position, were controlling. Under these decisions, a lockout was held to violate labor's guaranteed rights under section 7 of the National Labor Relations Act, and thus to constitute a violation of sections 8(a)(1) and (3) of the Act.

The National Labor Relations Board reversed the trial examiner, holding: (1) that the test of the legality of a lockout, as enunciated in *American Ship* and applied in *Evening News Ass'n*, is applicable to a pre-impasse lockout; (2) that there was no specific evidence of unlawful anti-union animus, the purposes of the lockout being those cited at the hearing; and (3) that the lockout was not inherently prejudicial to union interests and not devoid of significant economic justification and, therefore, specific evidence of anti-union intent was necessary. *Darling & Co.*, 171 N.L.R.B. No. 95, 2 Lab. Rel. Rep. (68 L.R.R.M.) 1133 (May 23, 1968).

Prior to *American Ship*, the general position of the National Labor Relations Board was that lockouts constituted prima facie unfair labor practices which violated sections 8(a)(1) and (3) of the National Labor Relations Act. The Board, however, recognized the right to lockout in two situations: (1) defensively, as a means to combat unlawful union activity, and (2) when the employer, in the face of an imminent strike, was acting to avert a special or unusual loss not consonant with an ordinary strike.

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2. 380 U.S. 300 (1965). The Court limited its holding to a temporary layoff of employees [used] solely as a means to bring economic pressure to bear in support of the employer's bargaining position, after an impasse has been reached. *American Ship Bldg. Co. v. NLRB* 300 U.S. 300 (1965). Id. at 308 (emphasis added).


4. Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection.


5. It shall be an unfair labor practice for an employer —

(1) to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 157 of this title;

(2) by discrimination in regard to hire or tenure of employment or any term or condition of employment to encourage or discourage membership in any labor organization.


6. 166 N.L.R.B. No. 6, 65 L.R.R.M. 1425 (June 29, 1967). The outcome of the Board's review of the trial examiners findings was predictable in light of *Evening News Ass'n*, which was decided subsequent to the issuance of the trial examiner's decision and which held that the *American Ship* test of the legality of a lockout was applicable to a deadlock situation. The Board stated in *Evening News Ass'n* that: [T]he legality of any lockout must be determined with regard to the criteria laid down by the Supreme Court. *American Ship* cautions against the promulgation of any hard and fast rule for determining whether a particular lockout is lawful.

Id. at 1427.

7. See cases cited note 3 supra.


9. *Building Contractors Ass'n*, 138 N.L.R.B. 1405 (1962) (employers could not assure customers of work completion once started, thus the stoppage would not
The basis of the Board's general position was its assumption of the power to balance economic weapons in the bargaining process. In assessing the relative economic powers of the parties, the Board made the general determination that a lockout, used offensively, was prejudicial to union interests and prima facie violative of sections 8(a)(1) and (3).10 Only when the lockout was utilized in circumstances embodied in the exceptions was it considered a defensive weapon and thus permissible employer activity.

The Supreme Court11 and legal commentators12 decried the Board's pre-American Ship position as a failure to discern the difference between economic interests and anti-union animus and activity.13 They further reasoned that the legality of a lockout, at least in some instances, could be inferred from the deletion in the enacted version of the National Labor Relations Act of a section of the draft which proscribed lockouts14 as well as from the explicit mention of lockouts in the Labor-Management Relations Act.15 Moreover, in several decisions, one involving a lockout, the Supreme Court rejected the Board's arbitration of economic weapons.16

In American Ship Bldg. Co. v. NLRB,17 the Court again refuted the Board's assumed power to act as arbiter of the economic weapons available to the parties of a labor dispute.18 The primary purpose of the Labor Acts was to redress the imbalance of economic power between labor and man-

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only involve serious economic loss to employers but could be dangerous to the lives, safety, and welfare of the public; Betts Cadillac, Olds, Inc., 96 N.L.R.B. 268 (1951) (Board justified a lockout because strike would halt work on customers' cars brought in for repair); In re Duluth Bottling Ass'n, 48 N.L.R.B. 1335 (1943) (lockout permitted to avoid peculiar economic loss-spoilage).

In NLRB v. Teamsters Local 449, 353 U.S. 87 (1957), the Supreme Court affirmed the Board's decision in Buffalo Linen Supply Co., 109 N.L.R.B. 447 (1954), which established a third exception when members of a multi-employer association locked out to frustrate the effects of a whipsaw strike.

10. The Board believed that management's arsenal of economic weapons was sufficient and refused to grant it the additional bargaining power which is commensurate with the right to lockout. The Board did, however, recognize the rights of management to make agreements with union representatives, hire permanent replacements after a strike, and provide for the production of its product elsewhere. NLRB v. MacKay Radio & Tel. Co., 304 U.S. 333 (1938); American Brake Shoe Co., 116 N.L.R.B. 820, 832 (1956).


13. This polemic was also evidenced among the courts of appeal which adopted conflicting positions. Compare Utah Plumbing & Heating Contractors Ass'n v. NLRB, 294 F.2d 165 (10th Cir. 1961) and Quaker State Oil Refining Corp. v. NLRB, 270 F.2d 40 (3d Cir. 1959), with NLRB v. Dalton Brick and Tile Corp., 301 F.2d 886 (5th Cir. 1962).


15. 29 U.S.C. § 158(d)(4) (1964) (for a 60-day period before termination of the contract, the contract terms are to continue in full force and effect, without resorting to strike or lockout); id. § 173(c) (conciliation service to induce parties to settle without resort to strike or lockout); id. § 176 (President can act when threatened or actual strike or lockout effects substantial part of industry); id. § 178(a) (conditions permitting district court to enjoin such strike or lockout).


17. 380 U.S. 300 (1965).
agement.\textsuperscript{19} It was Congress' intention that the perceived imbalance of bargaining power was corrected by the enumeration of certain rights of labor and the proscription of activities by management which in the past had interfere with employees' self-organization and the collective bargaining process. The duty to enforce labor's rights under section 7 of the Act was delegated to the Board. The Court summarized the Board's role when it stated:

Sections 8(a)(1) and (3) do not give the Board a general authority to assess the relative economic power of the adversaries in the bargaining process and to deny weapons to one party or the other because of its assessment of that party's bargaining power.\textsuperscript{20}

The criterion to determine a violation of the Act was not whether a lockout would mean additional bargaining power for management, but whether the use of the power would infringe upon the rights of labor to a degree not countenanced by Congress.

The Court's decision in \textit{American Ship} is a recognition that legislation neither guarantees labor victories nor insures that labor's position will be free of economic disadvantages.\textsuperscript{21} Section 8(a)(1) refers to interfering with, restraining, or coercing employees in the exercise of their rights under section 7 and is not a blanket proscription of such acts. In addition, section 8(a)(3) does not proscribe all acts which tend to discriminate against union interests. Although the Court recognized that a lockout might tend to discourage or encourage membership in labor organizations,\textsuperscript{22} it also recognized the legitimate business interests which management sought to protect. The Court therefore rejected the Board's general view with respect to lockouts as too narrow an interpretation of the guidelines set forth by Congress to effectuate the policy of the Acts in sections 7, 8(a)(1) and (3).

To assist the Board in future determinations, the Court clearly indicated the factors it considered germane to a finding that a lockout is not an unfair labor practice. Mr. Justice Stewart, speaking for the majority, stated that under the circumstances the factors are whether the lockout is "[1] inherently so prejudicial to union interests and [2] so devoid of significant economic justification that [3] no specific evidence of . . . anti-union animus is required."\textsuperscript{23}

While the Court in \textit{American Ship} was careful to limit its holding to the facts which were before it, a post-impasse lockout, the considerations

\textsuperscript{19} \textit{Id.} at 316. The purpose and policy of the Acts are to "eliminate those obstructions" to the free flow of commerce "by encouraging the practice and procedure of collective bargaining and by protecting the exercise by workers of full freedom of association, self organization . . . ." 29 U.S.C. § 151 (1964).

\textsuperscript{20} 380 U.S. at 317.

\textsuperscript{21} \textit{Id.} at 310.

\textsuperscript{22} In NLRB v. Teamsters Local 449, 353 U.S. 87 (1957), the Court stated that the protection afforded employees by the acts "[i]s not so absolute as to deny self-help by employers when legitimate interests of employees and employers collide." \textit{Id.} at 96. See Meltzer, \textit{Lockouts Under the LMRA: New Shadows on an Old Terrain}, 28 U. Chi. L. Rev. 614 (1961); Petro, \textit{The NLRB on Lockouts — II}, 3 Lab. L.J. 739, 801 (1952).

\textsuperscript{23} 380 U.S. at 312.
which the Court employed in its test to determine the legality of a lockout appeared to the Board, in the instant case, to be readily applicable and equally compelling in other lockout situations.\textsuperscript{24} The Board's adoption of this position is in direct contrast to their previous view that employment of a lockout constitutes a prima facie unfair labor practice and marks a partial withdrawal of the Board from its active role in the bargaining process. The Board continued its broad application of \textit{American Ship} based on the fact that that case did not set forth a strict and inflexible rule for determining whether a particular lockout was lawful. The absence of an impasse does not render \textit{American Ship} per se inapplicable but is "one of all the surrounding circumstances" in determining the legality of a pre-impasse lockout.\textsuperscript{25} The Board's change of position is made particularly evident by \textit{Darling} because the Board extended the application of the test to a pre-impasse lockout when it could have found that there was a threat of imminent strike and that unusual economic loss not consonant with an ordinary strike would have resulted,\textsuperscript{26} thereby placing the case within a traditional exception to its decisions prior to \textit{American Ship}.\textsuperscript{27}

In applying \textit{American Ship} to the pre-impasse lockout, the Board held that such a lockout is not inherently prejudicial to such essential union interests as the right to meaningful collective bargaining and the right to engage in concerted activity. The Board found that Darling and Company's sole purpose in locking out the production employees was to protect its direct and legitimate business interests and secure modification of union demands. Justice Stewart, in writing the majority opinion in \textit{American Ship}, referred to the intention of the company to secure modification of demands and acknowledged that "we cannot see that this intention is in any way inconsistent with the employees' rights to bargain collectively."\textsuperscript{28}

The same purpose prior to an impasse in contract negotiations is no more inherently prejudicial to the right to effectively and meaningfully bargain collectively than it is after an impasse. During the lockout union representatives remain free to negotiate in good faith with the employer. Moreover, the door to good faith negotiations must remain open: the employer's use of a pre-impasse lockout as a pretense to evade the collective bargaining process would clearly result in a violation of section 8(a)(5).\textsuperscript{29} Since the door to good faith negotiations is thus statutorily guaranteed, any impairment of the union's interest in collective bargaining will not be of such a degree as to be inherently prejudicial.

\textsuperscript{24} See Evening News Ass'n, 166 N.L.R.B. No. 6, 65 L.R.R.M. 1425 (June 29, 1967) (the Board characterized the negotiations as deadlocked); cf. Acme Markets, Inc., 156 N.L.R.B. 1452 (1966).


\textsuperscript{26} The union had communicated its intent to strike at its convenience and the 1962 strike during Darling and Company's shipping season caused extraordinary loss.

\textsuperscript{27} See cases cited note 9 supra.

\textsuperscript{28} 380 U.S. at 309.

\textsuperscript{29} Interrelated with sections 8(a)(1) and (3) is the statutory obligation of the employer to bargain in good faith. "It shall be an unfair labor practice for an employer . . . to refuse to bargain collectively with the representative of his employees . . . ." 29 U.S.C. § 158(a)(5) (1964).
Moreover, a pre-impasse lockout does not render the right to engage in concerted activity — the right to strike — a useless and meaningless economic weapon. Until the lockout is effected, the threat of a strike remains a real and forceful bargaining lever. Once the contract has terminated, a post- or pre-impasse lockout entails a work stoppage similar to that initiated by the employees in a strike. The real issue is who will have the power to determine the timing of the work stoppage. To grant labor the exclusive right to determine the timing of stoppage would permit unions to stall the bargaining process until the employer was susceptible to the greatest economic harm. Since the Act sought to redress the inequality of bargaining power, to arm labor with this power would leave the employer at a definite disadvantage with no countervailing weapon, and thereby foster inequality. There is no statutory provision which guarantees labor's right to determine the timing of work stoppage or which guarantees a position free from economic disadvantage. A lockout, pre- or post-impasse, merely permits management a voice in the timing of the work stoppage.

It would appear that a pre-impasse lockout is no more inherently prejudicial to union interests than the hiring of permanent replacements for striking workers which has been sanctioned by the Supreme Court. The exercise of labor's statutory right to strike jeopardizes their relationship with the employer who is not obligated to rehire the strikers if all positions are occupied by replacements. A lockout, in contrast, is merely a temporary discontinuation of employment and is thus less prejudicial to union interests. Therefore, a temporary severance of employment is not a rejection of the basic principles of the Act and does not flaunt its basic purpose — to alleviate strife by redressing the inequality of bargaining power.

*American Ship* requires the employer to show that his decision to lockout was motivated by significant economic justification. This justification consists of a real and direct interest in negotiations which will have a definite impact upon the employer's future business relations with

30. The act of stalling is inimical to the bargaining process and, standing alone, would be very difficult to detect. To eliminate activities by labor organizations, officers, and members which burdened and obstructed commerce, the Labor-Management Relations Act enumerated certain unfair labor practices of labor. Section 8(b) (3) makes it an unfair labor practice "to refuse to bargain collectively with an employer . . . ." 29 U.S.C. § 158(b) (3) (1964).

31. In NLRB v. Teamsters Local 449, 353 U.S. 87 (1957), the Court recognized that the protection of the right to strike is not so absolute as to deny self-help to employer when the legitimate interests of the parties collide. *Id.* at 96. See *American Ship Bldg. Co. v. NLRB*, 380 U.S. 300, 313 (1965) (Act does not immunize employees from the economic disadvantages attendant to a bargaining dispute).


33. The Labor-Management Relations Act provides: "Employees shall have the right to . . . engage in . . . concerted activities for the purpose of collective bargaining . . . ." 29 U.S.C. § 157 (1964); "[n]othing in this subchapter, except as specifically provided for herein, shall be construed so as either to interfere with or impede or diminish in any way the right to strike . . . ." 29 U.S.C. § 163 (1964).
his employees. An employer's interest is no less significant, and is perhaps greater, in a pre-impasse lockout. In the instant case, Darling and Company was immediately involved in negotiations and any lengthy delay in reaching a settlement would place the company at a definite disadvantage with employees poised to strike during the heart of its shipping season. In the light of past work stoppages and the union's notice that it would strike at its convenience, Darling and Company was legitimately concerned over the timing of work stoppage and was justified in applying economic pressure to gain acceptance of its own proposals. Hence, the Board found significant economic justification for the lockout.

When no significant economic justification is shown, the Supreme Court, in Great Dane Trailers, Inc. and Fleetwood Trailer Co. has held that the employer's activity is an unfair labor practice regardless of the presence or absence of anti-union animus. In light of these cases, it is virtually inconceivable that employers charged with violations of the Act will not allege some economic justification for a lockout.

Since the pre-impasse lockout in Darling & Co. created no inherent prejudice and significant economic justification was found to exist, the conduct was prima facie lawful and evidence of anti-union animus was necessary to substantiate the allegation that the lockout constituted 8(a) (1) and (3) violations. Anti-union animus may be proved either by specific evidence or by inference from the employer's activities. Since employers are not likely to leave records or other proof indicating such motive, improper motive is seldom capable of specific proof. Thus the determinative issue most often will be whether an inference of unlawful intent may be drawn from the employer's activities. Once significant justification is established, however, the majority in NLRB v. Brown and American Ship require a great degree of evidence to overcome the presumption of lawfulness. The Court in Brown stated that the inference of unlawful intent must be the only reasonable inference and American Ship referred to an inference “so compelling that it is justifiable to disbelieve the employer's protestations of innocent purpose.” In contrast to a simple weighing of

34. Evening News Ass'n, 166 N.L.R.B. No. 6, 65 L.R.R.M. 1425, 1427 (June 29, 1967); Acme Markets, Inc., 156 N.L.R.B. 1452 (1966) (owner of unionized stores which were members of multi-employer unit locked out his non-union, non-member stores doing business in close proximity to unit members to protect multi-employer association interests); Friedland Painting Co., 158 N.L.R.B. 571 (1966) (amount of work to be performed in an area was speculative, therefore interests held indirect).
39. Id. at 287.
40. 380 U.S. at 311-12.
interests, this represents a “thumb on the scales” approach to deciding the legality of a lockout.

The Board in Darling & Co. found no specific evidence of anti-union animus. Moreover, in light of the Board’s explicit assertion that the lockout was not inherently prejudicial and its finding of significant economic justification, it found that it could not infer unlawful intent.

In the final analysis, by establishing the standards of American Ship, the Court has deprived the Board of a great degree of flexibility and established for itself and the Board a new standard by which to measure the legality of a lockout. Despite the explicit statutory protection accorded a strike and the fact that a lockout does not enjoy a similar position, the Supreme Court and the Board have added a post- and pre-impasse lockout, respectively, to the employer’s arsenal of economic weapons. In response to the Court’s mandate in American Ship, the Board has withdrawn from its prior position as the party who dominated the bargaining process, because it acted as an arbiter of economic weapons, and has assumed its proper function of enforcing labor’s guaranteed rights under section 7. It is unlikely that the courts will restrict the test of the legality of a lockout to the narrow factual situation posed in American Ship. In light of Darling & Co., it is foreseeable, if not already a reality, that a lockout in support of legitimate business interests, absent specific proof of anti-union animus, will be an economic correlative to a strike.

Stephen A. McBride

TAXATION — DISTRIBUTION OF STOCK — SECTION 355 OF THE INTERNAL REVENUE CODE IS CONSTRUED WHERE SUCCESSIVE DISTRIBUTIONS OF STOCK RIGHTS ARE MADE TO CORPORATE SHAREHOLDERS PERSUANT TO A SPIN-OFF.

Commissioner v. Gordon (U.S. 1968)

Taxpayers Gordon and Baan, residents of New York and California respectively, were stockholders in Pacific Telephone and Telegraph Company (hereinafter Pacific), a subsidiary of American Telephone and Tele-
graph Company. Pacific provided telephone service in California, Idaho, Oregon, and Washington and, for business reasons, decided to divide its operations into two corporations. Northwest Bell Telephone Company (hereinafter Northwest) was therefore created in accordance with a Pacific distribution plan to take over Pacific's non-California operations.1 Under this spin-off plan Pacific transferred its Washington, Oregon, and Idaho assets to Northwest which assumed Pacific's liabilities arising out of Pacific's operations in those States. In exchange, Pacific received all of Northwest's stock and Northwest's demand note for $200 million. Also pursuant to this plan, Pacific stockholders were to receive stock rights on the basis of their ownership in Pacific which would allow them to purchase the stock of Northwest.2 In 1961, Pacific distributed stock rights representing 57 percent of the total Northwest shares to its shareholders. Six rights plus $16 entitled each Pacific shareholder to receive one Northwest share. Two years later, in 1963, Pacific distributed stock rights representing the remaining 43 percent of Northwest shares.

Shareholders Gordon and Baan exercised their stock rights received pursuant to the 1961 distribution, but did not then report any income as a result of receiving the Northwest shares on the basis that the stock rights distribution was tax-free under section 355 of the Internal Revenue Code.3 The Commissioner assessed deficiencies against both taxpayers arguing that the Pacific distribution did not meet the nonrecognition requirements of section 355. Both taxpayers petitioned the Tax Court for a redetermination of the Commissioner's finding and, after consolidating the two actions, the Tax Court held that the taxpayers could avail themselves of section 355 since that section did not preclude nonrecognition in a distribution involving stock rights rather than stock.4 The Commissioner, taking advantage of the taxpayers' diversity of citizenship, appealed the Tax Court's ruling to the Courts of Appeal for the Second and Ninth Circuits. In Commissioner v. Gordon,5 the Second Circuit, in a 2-1 decision, affirmed as to shareholder Gordon, holding that minor departures from the requirements of section 355 were not fatal to the taxpayer's claim for nonrecognition status under the Pacific stock rights distribution plan since the distribution

1. The transaction under consideration involves a spin-off as distinguished from a split-off or split-up. In a spin-off the controlling corporation transfers some of its assets to an existing or newly created corporation (the controlled corporation) in exchange for the stock of the controlled corporation. This stock is then distributed to the shareholders of the controlling corporation. The split-off is similar to a spin-off except that in a split-off the shareholders must surrender some of their original shares in the controlling corporation. The split-up involves a distribution to the shareholders of the stock of two or more existing or newly created subsidiaries incident to a complete liquidation of the distributing corporation. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders § 11.01, at 450-51 (2d ed. 1966).
2. For a complete description of the spin-off plan see Oscar E. Baan, 45 T.C. 71, 77-78 (1965).
3. INT. REV. Code of 1954, § 355. For the complete language of the relevant Code sections see note 19 infra.
5. 382 F.2d 499 (2d Cir. 1967).
had a valid business purpose and was free from a tax avoidance scheme.\textsuperscript{6} In \textit{Commissioner v. Baan},\textsuperscript{7} however, the Ninth Circuit interpreted section 355 literally and held that Pacific's plan was not a distribution "with respect to stock" as required by section 355 but was rather a sale of stock for a cash consideration and therefore clearly outside the scope of nonrecognition treatment.\textsuperscript{8} Additionally, this court rejected the taxpayer's argument that the 1961 and 1963 distributions should be viewed as parts of a single transaction and held that since there was a piecemeal distribution which extended over a period of 2 years, the taxpayers could not invoke the protection of section 355.\textsuperscript{9} On appeal the Supreme Court reversed the decision of the Second Circuit and affirmed that of the Ninth Circuit, holding that Pacific's failure to distribute control in Northwest in the initial stock rights distribution together with its failure to absolutely commit itself to distribute the remaining shares was sufficient to take the transaction outside the scope of section 355. \textit{Commissioner v. Gordon}, 391 U.S. 83 (1968).

The tax-free spin-off was first permitted by Congress in the Revenue Act of 1924\textsuperscript{10} when it was recognized that this type of corporate reorganization was an "ordinary business [transaction which should] not be prevented on account of provisions of the tax law."\textsuperscript{11} Unfortunately the tax laws permitting such tax-free status were so loosely drafted that by utilizing various corporate reorganization schemes shareholders could avoid the tax consequences of incurring dividend income and receive more favorable capital gain treatment.\textsuperscript{12} To counteract the many reorganization plans designed to circumvent the 1924 Act, Congress in 1934 eliminated all spin-off distributions from the protection of the tax laws.\textsuperscript{13} Distributions of stock pursuant to spin-offs were not again given special tax-free treatment until 1951 when Congress, by amending the Internal Revenue Code of 1939,\textsuperscript{14} again recognized the need for giving nonrecognition treatment to transactions which were designed merely to allocate corporate capital rather than to distribute income.\textsuperscript{15} In this amendment Congress enunciated

\begin{enumerate}
\item \textit{Id.} at 503–05.
\item 382 F.2d 485 (9th Cir. 1967).
\item \textit{Id.} at 493.
\item \textit{Id.} at 496–97.
\item Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 256.
\item Int. Rev. Cong. of 1939, § 112(b) (11), \textit{added by} 65 Stat. 493.
\item The Senate Committee on Finance reported that "[t]his section has been included in the bill because your committee believes it is economically unsound to
\end{enumerate}
with somewhat greater specificity than in the 1924 Act the exact manner in which a spin-off should be accomplished with concomitant tax immunity to the corporate shareholders. These more specific guidelines together with other strengthening modifications became section 355 of the Internal Revenue Code of 1954. 

Section 355 allows corporate distributions of stock or securities17 to shareholders in connection with a spin-off, a split-up, or a split-off18 to be accorded nonrecognition treatment when four basic requirements are met:  

1. Solely stock or securities of the controlled corporation must be distributed to shareholders of the controlling corporation in ex-


17. Corporate distributions may consist of cash, property, debt or contractual obligations, or stock. The stock distribution referred to in section 355 concerns a distribution of stock in the controlled corporation by the controlling corporation to the shareholders of the latter and is not to be confused with a stock dividend which is a distribution of the corporation’s own stock to its shareholders. See B. BITTKE & J. EUSTICE, supra note 1, §§ 5.20–63.

18. See note 1 supra.


(a) Effect on Distributees.—  

(1) General rule.—If—  

(A) a corporation (referred to in this section as the “distributing corporation”)—  

(i) distributes to a shareholder, with respect to its stock, or  

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as “controlled corporation”) which it controls immediately before the distribution,  

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),  

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and  

(D) as part of the distribution, the distributing corporation distributes—  

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or  

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,  

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.  

(b) Requirements as to Active Business.—  

(1) In General.—Subsection (a) shall apply only if either—  

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of
change for their securities or with respect to the amount of their stock in the controlling corporation;\textsuperscript{20}

2. The distribution must not be a device designed to avoid the imposition of income tax liability;\textsuperscript{21}

3. Both the distributing and the controlled corporation must be engaged in the active conduct of business immediately after the distribution and the newly formed business must not have been acquired within 5 years of the date of distribution in a transaction in which gain or loss is recognized;\textsuperscript{22} and

4. The distributing corporation must distribute all the stock or securities in the controlled corporation which it held immediately before the distribution or, in the alternative, at least 80 percent of that stock, provided it can be shown that the stock retained was not in pursuance of a tax avoidance plan.\textsuperscript{23}

The facts of the instant case give rise to three distinct problems in the construction of section 355 — first, whether the distribution of Northwest stock pursuant to the exercise of stock rights and payment of a cash consideration was a distribution with respect to stock within subsection 355(a) (1) (A) (i); second, since Pacific recognized gain in acquiring the newly created corporation as a result of receiving the $200 million demand note from Northwest, whether the active business requirements of subsection 355(b) (2) (C) had been met; and third, whether such a corporate

\textsuperscript{20} INT. REV. CODE of 1954, § 355(a) (1) (A).
\textsuperscript{21} INT. REV. CODE of 1954, § 355(a) (1) (B).
\textsuperscript{22} INT. REV. CODE of 1954, §§ 355(a) (1) (C), 355(b) (2) (C). Section 355 contains three additional active business requirements none of which, however, are pertinent to the facts of the instant case.

\textsuperscript{23} INT. REV. CODE of 1954, §§ 355(a) (1) (D), 368(c).
distribution of stock could be accomplished over a 2-year period rather than only in an immediate transfer. Unfortunately the Supreme Court did not resolve all the questions presented but confined itself to resolving only the 2-year distribution issue.

The distribution issue facing the Court was whether subsection 355 (a) (1) (D) permits separate successive distributions of 57 percent and 43 percent of the stock of the controlled corporation over a 2-year period or whether that subsection requires a complete and immediate single distribution. This Code provision mandates a complete or at minimum 80 percent divestiture of the stock which the controlling corporation acquired in the controlled corporation immediately before distribution. In resolving this issue, the Second Circuit stated that there was "nothing on the face of this subsection that relates to the number of transactions ... which may be contained in a distribution." 24 The court further reasoned that the "device" language of subsection 355(a) (1) (B) was more than adequate to cover multi-distribution schemes which might be designed to avoid taxes and that since the Pacific distribution was not such a tax avoidance device, nonrecognition was proper. 25 The Ninth Circuit took a contrary position, however, based on a more literal construction of the statute. The court stated:

[S]ection 355 requires that there be a single transaction in which a controlling interest is transferred and that for two or more distributions to be entitled to treatment as a single transaction transferring control of the controlled corporation to the shareholders of the distributing corporation, such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions . . . . 26

The Supreme Court took a middle course between the conflicting circuit court positions and reasoned that since Pacific had no definite commitment to divest itself of the remaining shares after the initial distribution of 57 percent, it had not met the requirement of distributing control. 27 The Court was concerned that the future tax consequences of the initial 57 percent distribution in 1961 were undeterminable since under section 355 there is no nonrecognition treatment until control, i.e., 80 percent, is distributed. Such distribution of control did not occur in the instant case until 1963 when Pacific divested itself of the remaining 43 percent, which distribution it was not contractually bound to make. The Supreme Court specifically withheld an opinion as to the tax impact if Pacific had been contractually committed to make the 1963 distributions; 28 however, the

24. 382 F.2d at 508.
25. Id. For a similar analysis in agreement with the Second Circuit's position see Note, Variations on the Spin-Off As Non-Taxable Distributions, 67 COLUM. L. REV. 1544 (1967) and 81 HARV. L. REV. 482 (1967).
26. 382 F.2d at 498 (emphasis added). See also 56 CALIF. L. REV. 220 (1968).
27. 391 U.S. at 96. Control is defined in INT. REV. CODE of 1954, § 368(c) as stock possessing 80 percent of the voting power of all classes of stock or 80 percent of the total number of shares of all other classes of stock.
Court did indicate in dictum that before one transaction can be characterized as a first step in a distribution plan, there must be a binding commitment to take the later steps. 29

The rationale employed by the Court, though in accord with judicial precedent, 30 is subject to question insofar as it applies to section 355 distributions. Although a clear indication of congressional intent in the enactment of section 355 concerning multi-step distribution plans is lacking, a close reading of the statutory language indicates that even if the distributing corporation bound itself by contract to complete such a plan, this might not be sufficient to meet the particularity of section 355’s requirements. The specific language employed in the section seemingly precludes such a distribution. Subsections 355(a)(1)(A) and (a)(1)(D) are both premised on the requirement that the distributing corporation have control of the spun-off corporation immediately before the distribution. In the instant case, Pacific’s 1963 distribution of stock rights to the remaining 43 percent of Northwest’s stock cannot be said to fit the meaning of these subsections unless the words “immediately before” can be construed to relate to the date of the binding commitment and the distribution itself be considered to have taken place on that date. It is particularly significant to note that subsection 355(b)(2)(B) contemplates a designated date of distribution which will be the point of departure for the Commissioner to determine whether the section’s active business requirements have been met. Assuming that Pacific had made a binding commitment to distribute all of its stock in 1961, to decide that 1961 was the date of distribution would be to decide that Pacific had in effect distributed control of Northwest in 1961 although it still retained 43 percent of Northwest’s stock until 1963 — a period of 2 years. A further indication that Congress contemplated a complete and immediate divestiture was its concern that any retention of stock by the distributing corporation might encourage plans designed to avoid income tax liability. 31 To permit some proper corporate flexibility Congress did enact subsection 355(a)(1)(D)(ii) which allowed retention of up to 20 percent of the stock; however, this is permitted only on condition that the distributing corporation explain to the Commissioner the reasons for such retention. By making an initial distribution and a commitment to distribute any remaining stock within 5 years, for example, a distributing corporation could easily circumvent this provision. In such a circumstance although the distributing corporation would be required to distribute the remaining stock within 5 years it could retain rather than divest itself of control during the interim period between the initial and final steps of the transaction. Thus, in the wording of these subsections, it appears that only one specific and certain distribution date was contemplated throughout section 355.

29. 391 U.S. at 96.
30. See, e.g., Commissioner v. Schumacker Wall Board Corp., 93 F.2d 79 (9th Cir. 1937). For a commentary on this approach see Mintz & Plumb, Step Transactions in Corporate Reorganizations, N.Y.U. 12TH INST. ON FED. TAX 247 (1954).
As previously indicated the Supreme Court decided only the issue of whether section 355 permitted a distribution to take part in two distinct steps and left unanswered important questions on which the Second and Ninth Circuits took disparate important positions. These questions will ultimately face the courts again and their resolution will be vital the planning of future corporate reorganizations. The remainder of this Note will focus on these unanswered issues.

The initial unresolved question concerns the requirement of subsection 355(a)(1)(A) that the stock of the spun-off corporation be distributed with respect to the stock of the distributing corporation. The Commissioner argued in both circuit courts that Pacific's distribution of stock rights exercisable upon payment of $16 was not such a distribution of stock, but was more in the nature of a sale of stock for a cash consideration. The Second Circuit in Gordon rejected this argument and decided that the phrase "distributes . . . with respect to its stock" did not preclude a distribution by a corporation with respect to its stock plus a consideration.\(^32\)

In so deciding the Second Circuit ignored the fact that the distribution was of stock rights and showed no concern for whether stock rights could be considered within the term "stock." The court stated: "[I]t is the actual distribution of the Northwest stock upon the exercise of the rights that is the relevant event and the use of the stock rights as a mere mechanism to accomplish this result should be disregarded."\(^33\) The Ninth Circuit in Baan, on the other hand, decided that the phrase "distributes . . . with respect to its stock" was used consistently throughout the Internal Revenue Code as a term of art and therefore should be accorded the literal meaning which Congress intended. The court, in recognizing that stock rights were not included within the term stock, characterized the Pacific distribution as a sale of stock rights and concluded that the Code language, since it makes no mention of consideration, precluded a sale for a cash consideration. It held, therefore, that the transaction was outside the intended scope of section 355.\(^34\)

The Ninth Circuit's literal approach to the stock-stock rights issue appears to be the correct interpretation of section 355 and, reasoning along these lines, the finding of a sale of rights is a proper result. With respect to the Second Circuit's decision to ignore the fact that stock rights rather than stock was distributed, it is important to note that the court characterized the Pacific distribution plan as essentially a step transaction — a judicial method of applying substance rather than form to the income tax laws. This method was first expressed in Bassick v. Commissioner,\(^35\) where the Second Circuit stated that "[f]or income tax purposes, the component

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32. 382 F.2d at 505.
33. Id. For analysis in accord with the position taken by the Second Circuit see Note, Variations on the Spin-Off As Non-Taxable Distributions, 67 COLUM. L. REV. 1544 (1967), 56 CALIF. L. REV. 220 (1968), 81 HARV. L. REV. 482 (1967), and 43 NOTRE DAME L. 389 (1968).
34. 382 F.2d at 495.
steps of a single transaction cannot be treated separately."36 Following this approach, the lower court in Gordon considered a distribution of stock rights to be merely a step leading to the distribution of stock and considered this initial step to be a nonseparable aspect of the whole stock distribution plan. The court premised its approach on the Supreme Court's opinion in Palmer v. Commissioner,37 and interpreted Palmer as holding that the issuance of stock rights may be disregarded for tax purposes and therefore tax consequences flow not from the issuance of the rights but rather from their exercise.38 The Second Circuit therefore concluded that the relevant event for tax purposes was the distribution of the stock upon exercise of the stock rights and not upon their issuance.39 This conclusion and interpretation of Palmer is questionable in light of a footnote in the instant case wherein the Supreme Court specifically noted that it "has not . . . been authoritatively settled whether an issue of rights to purchase at less than fair market value itself constitutes a dividend, or [whether] the dividend occurs only on the actual purchase."40 Should it be decided by the Supreme Court in a future case that a dividend occurs on issuance,41 then the step transaction approach, which disregards the issuance of stock rights as having a separate tax significance, would lose some of its force since the issuance of stock rights apparently could not then be disregarded.

Further support for the Ninth Circuit's conclusion that the distribution of stock rights in itself is not an adequate substitute for the distribution of stock and therefore outside the scope of section 355 is found in the analogous area of corporate reorganizations. In this area the Supreme Court has determined that where it is required that stock be issued, the issuance of stock rights will not be sufficient to meet that requirement.42 Furthermore, in passing the predecessor to subsection 355(a)(1)(A) in 1951, Congress itself stated that the section applies "where only stock . . .

36. 85 F.2d at 10. Accord, Prairee Oil & Gas Co. v. Motter, 66 F.2d 309 (10th Cir. 1933); Walter S. Heller, 2 T.C. 371 (1943). In Heller the court said: "In determining the substance of a transaction it is proper to consider the situation as it existed at the beginning and end of the series of steps . . . and the relation between the various steps." Id. at 383.
37. 302 U.S. 63 (1937).
38. 382 F.2d at 505.
39. Id.
40. 391 U.S. at 89 n.4. This statement apparently was inserted by the Court because the Palmer decision has been too broadly interpreted by the lower courts. Indicative of this fact was the Tax Court's definitive statement relying on the Palmer rationale, that the issuance of the rights could not be considered as a dividend. The Tax Court by this statement rejected the Commissioner's contention that the rights rather than the stock were the subject of the distribution. Oscar E. Baan, 45 T.C. 71, 91 (1965).
41. A number of commentators adopt the viewpoint that the issuance of a right represents more than a mere offer for sale, and point to provisions of the 1954 Code which indicate that rights are property and therefore the issuance of a right is actually a distribution of a property-dividend. Carlson, Taxation of "Taxable" Stock Rights: The Strange Persistence of Palmer v. Commissioner, 23 Tax L. Rev. 129 (1968); Whiteside, Income Tax Consequences of Distributions of Stock Rights to Shareholders, 66 Yale L.J. 1016 (1957).
is distributed by the corporation or corporations." Moreover, in other sections of the Code where it was adjudged to be necessary, Congress expressly included stock rights within the ambit of the term stock. In comparing these sections with section 355 it appears logical to conclude that had Congress deemed it desirable or necessary stock rights and stock would have been given similar treatment under section 355.

Although stock rights do not appear to be included within the purview of the term stock under subsection 355(a)(1)(A), the implications of a simple stock rights distribution without consideration at first blush appear no different from those of a distribution of the stock itself. Absent the requirement that a large amount of cash be expended in order to exercise the rights, a shareholder could simply exchange his stock rights for stock and be in the same position as if stock had been distributed to him in the initial offering. The Pacific distribution plan creates an additional problem, however, because it required each stockholder to tender $16 as well as six stock rights in order to receive one share of Northwest stock. Thus, the distribution was not exclusively with respect to stock as is specifically required by section 355, but was with respect to stock plus a consideration. This spin-off thus was not a spin-off in the classic sense in which stock is merely distributed, but in addition served as a capital-raising venture for the corporation.

The Second Circuit, in answering the Commissioner's contention that the distribution was actually a sale for a cash consideration, separated the component parts of the transaction and stated that the distribution was "with respect to stock," but in addition thereto the shareholders had contributed capital to the corporation. If this transaction were not so separated, it justifiably could be termed a sale and clearly would not have met the requirements of section 355. The effect of the Second Circuit's characterization of this transaction as a distribution of property together with a separate capital contribution would be to give Pacific an unjustifiable tax windfall since a corporation neither recognizes gain on a distribution of property to its shareholders with respect to stock nor realizes any income from a contribution to its capital. However, if the transaction were characterized as a sale of property, Pacific would be required to recognize gain to the extent that the price paid for the property exceeded its cost basis. In the instant case Pacific did in fact report such recognizable

44. See, e.g., INT. REV. CODE of 1954, §§ 305, 306(d).
45. The Ninth Circuit's position is further enhanced since the Treasury Regulations provide that: "[f]or the purpose of section 355, stock rights or stock warrants are not included in the term 'stock and securities.'" Treas. Reg. § 1.355-1 (1955). For a discussion on the weight to be accorded Treasury Regulations see Griswold, A Summary of the Regulations Problem, 54 Harv. L. Rev. 398 (1941); Additionally, the Pacific distribution plan was effected in the face of an adverse private ruling by the Commissioner as to the plan's tax consequences with respect to the Pacific stockholders. See Oscar E. Baan, 45 T.C. 71, 85-86 (1965).
46. 382 F.2d at 505.
47. INT. REV. CODE of 1954, § 311.
gain from the sale of stock rights in its 1961 tax return.\textsuperscript{49} If the transaction is characterized as a sale of property as it relates to the distributing corporation, it seems illogical to characterize that same transaction as a capital contribution and not a sale as it relates to the taxpayer.

It also is important to note that the Code phrase "distributes . . . with respect to its stock" appears to be a term of art used with consistency throughout the Code\textsuperscript{50} to refer to distributions without cash consideration, not to sales.\textsuperscript{51} Since payment of cash in addition to the stock rights was necessary to the Pacific distribution plan, this transaction would seem to fall outside the meaning of this phrase.

In addition, the requirement of the Pacific distribution that a cash consideration be paid in order to obtain Northwest stock impliedly contravenes the doctrine of continuity of interest which requires that the original owners of the controlling corporation retain a continuing interest in the spun-off corporation.\textsuperscript{52} Such a requirement may have the effect of restricting section 355's availability to the stockholders of the controlling corporation.\textsuperscript{53} That this continuity may be hampered is not merely a theoretical argument since it is not unreasonable to assume that some of the Pacific shareholders may have lacked the requisite cash to exercise their stock rights and preserve their interests.\textsuperscript{54} The Second Circuit answered this

\textsuperscript{49} Oscar E. Baan, 45 T.C. 71, 83 (1965). It should be noted that even if Pacific had not properly reported this income as required by section 351(b), the fact that the gain was recognizable would still lead to the conclusion that this transaction was a sale.

\textsuperscript{50} See, e.g., INT. REV. CODE of 1954, § 301 (distributions of property); § 305 (distributions of stock and stock rights); § 307 (basis of stock and stock rights acquired in distributions); § 311 (taxability of corporation on distributions); and § 312 (effect of distribution on corporate earnings and profits).

\textsuperscript{51} Thus, INT. REV. CODE of 1954, § 311(a) specifically provides that a corporation shall not recognize gain or loss on a distribution ("with respect to its stock") of its stock or property. Therefore a distribution with respect to stock could not include a sale of property since on a sale the corporation would be required to recognize gain to the extent the purchase price was greater than the basis of the property. INT. REV. CODE of 1954, §§ 1001, 1002. Additionally, INT. REV. CODE of 1954, § 355(a)(2)(B) provides that the distributing corporation may receive stock back from the shareholder but no provision is made for the receipt of cash by the distributing corporation. Commissioner v. Baan, 382 F.2d 485, 489 (1967).

\textsuperscript{52} The continuity of interest requirement that was apparently incorporated into section 355 by Congress was originally a judicially imposed doctrine. LeTulle v. Scofield, 308 U.S. 415 (1940); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933). Its purpose is to deny tax-free status to transactions which have the appearance of a sale. See B. Bittker & J. Eustice, supra note 1, §§ 11.09, 12.11. For a criticism of this doctrine see Griswold, "Securities" and "Continuity of Interest", 58 HARV. L. REV. 705 (1945).

\textsuperscript{53} Treas. Reg. § 1.355-2(c) (1955). This point was aptly made in Petitioner's Brief:

The fundamental basis for non-recognition of gain or loss under Section 355 (and the standard reorganization sections) is that no tax should be imposed when the same people continue to own the same businesses with only formal changes in business organization.

Brief for Petitioner at 24, Commissioner v. Baan, 382 F.2d 485 (9th Cir. 1967).

\textsuperscript{54} Although 95 percent of the Pacific stockholders exercised their stock rights in Northwest, the dominant shareholder of Pacific, A.T.&T., comprised 89 percent of this group. Thus, of the shareholders who owned the remaining 11 percent of Pacific, only 6 percent, a little more than half of the minority, exercised rather than sold their rights. In a situation where a great block of shares is not owned by any one shareholder, it can be assumed that this same lack of continuity of ownership would occur.
argument by applying a retrospective test and observed that a continuity of ownership by Pacific shareholders was in fact maintained,\textsuperscript{55} whereas the Ninth Circuit indicated that a prospective test was appropriate since at the time of the initial distribution it remained uncertain whether continuity would be preserved in the future.\textsuperscript{56} In evaluating the two approaches, it would seem that the prospective test is to be preferred because it has the advantage of allowing the shareholder-taxpayer to structure his financial affairs in light of predictable tax consequences. Under the retrospective test the shareholder-taxpayer would be placed in the position of guessing whether a distribution will or will not qualify under section 355, and thereby be subject to a possible tax liability not originally contemplated.

The second question left unanswered both by the Supreme Court and the Ninth Circuit involves the application of the active business requirement of subsection 355(b)(2)(C). Under this subsection if a trade or business is acquired within 5 years of the date of a stock distribution in a transaction in which gain or loss is recognized the distribution will not be accorded nonrecognition treatment. Since Pacific received "boot"\textsuperscript{57} in the form of a $200 million demand note from Northwest which would be a recognizable gain\textsuperscript{58} under section 351, the Commissioner contended in both \textit{Baan} and \textit{Gordon} that the Pacific distribution did not satisfy the active business requirements. Notwithstanding the fact that Pacific received a recognizable gain, the Second Circuit concluded that the Pacific distribution of Northwest stock was still within the protection of section 355.\textsuperscript{59} The court interpreted subsection 355(b)(2)(C) to mean that gain or loss is only relevant when \textit{new} assets are brought into the distributing corporation's structure\textsuperscript{60} and that the subsection was not applicable if \textit{existing} assets were merely transferred to the newly created corporation. Under this analysis, the court would implicitly apply this subsection only to the acquisition of new assets from third parties. Such an interpretation is not without merit since the enactment of subsection 355(b)(2)(C) was "apparently intended to prevent temporary purchases of going businesses [from third parties] as a method of distributing liquid assets to shareholders."

\textsuperscript{55} 382 F.2d at 506.

\textsuperscript{56} 382 F.2d at 495.

\textsuperscript{57} Boot is generally considered to be money or "other" property which is considered recognition-type property, as opposed to stock or securities which receive nonrecognition treatment under the reorganization sections of the Internal Revenue Code. For a discussion of the nature of boot see J. MERTENS, \textit{Law of Federal Income Taxation} \S 20.147 (Zimet & Weiss rev. 1965).

\textsuperscript{58} Section 351 states that no gain or loss will be recognized if property is transferred to a corporation solely in exchange for stock and securities of such corporations and immediately after such exchange the transferees control the corporation. \textit{Int. Rev. Code} of 1954, \S 351. The demand note received by Pacific would not be considered within the term stock or securities and Pacific would therefore be required to recognize gain. Finellas Ice & Storage Co. v. Commissioner, 287 U.S. 462 (1933).

\textsuperscript{59} 382 F.2d at 507.

\textsuperscript{60} Id. Actually Pacific received more than $500,000 in new assets when the rights were exercised; therefore the court's analysis can be questioned.

The correct interpretation of this subsection, however, remains uncertain since the Tax Court has pointed out that nowhere in the committee reports is the reason behind the enactment of 355(b)(2)(C) officially stated. Moreover, if this subsection were enacted only as a means to prevent such temporary purchases, the "device" language of subsection 355(a)(1)(B) would seemingly have accomplished that goal. According to subsection 355(a)(1)(B), if a transaction is a device to distribute earnings and profits of the distributing corporation, the distribution will not be protected by section 355. Thus, a purchase and subsequent liquidation of the purchased business will be considered a device to convert what normally would be ordinary income into a capital gain and if such a device is used, the shareholders of the purchasing corporation would not be accorded section 355 nonrecognition treatment. Since a distribution must meet both the device and active business requirements of section 355, unduly limiting the active business test to preclude only that which is already prevented by the device test would serve to reduce the active business requirement to a mere redundancy.

The suggestion has been made by several commentators that subsection 355(b)(2)(C) be reworded by Congress to avoid misinterpretation since in its present form it has not effectively obviated the evils which it was designed to eliminate while at the same time has encompassed transactions not meant to be within its scope. Indicative of such an overextension of the prophylactic language of subsection 355(b)(2)(C) is the situation where corporation B, a subsidiary of corporation A, purchases another business at a price which equals the adjusted basis of the newly acquired business. In this type of corporate transaction, no gain or loss is recognized on the corporate level and that fact would seem to keep the transaction outside the literal language of subsection 355(b)(2)(C). Therefore, upon a subsequent spin-off of corporation B's stock to the shareholders of corporation A, nonrecognition would not be denied due to corporation A's failure to meet the literal language of subsection 355(b)(2)(C) — "in which gain or loss was recognized." If this stock is subsequently sold by corporation A's shareholders, any gain realized by them would thus be considered as capital gain. It seems inappropriate to permit nonrecognition in this circumstance since this is the kind of transaction at which this subsection was specifically directed because of the danger that ordinary income will be converted into capital gain. Conversely, in a corporate transaction not designed to avoid the tax laws, the receipt of any boot on the corporate level, no matter how minimal, could result in the disqualification of the transaction from nonrecognition treatment as

64. See Int. Rev. Code of 1954, § 1001. But see BITTKER & EUSTICE, supra note 1, at 470, where it is suggested that the Court would interpret the term recognized to be
if the new business had been acquired entirely for cash.\textsuperscript{65} If Congress
wishes to correct the weaknesses in this statute it should concern itself
less with the form of the transaction (the recognition of gain or loss) and
more with the substance or nature of the transaction (the possible con-
version of ordinary income into capital gain).

In final analysis, the dichotomy that exists between the Second and
Ninth Circuit opinions reduces itself to whether section 355 should be
interpreted literally or interpreted in light of supposed congressional intent.
The individual taxpayer is invoking the protection of this section; it is
therefore his responsibility to insure that his actions strictly follow the
applicable Code requirements. Nonrecognition in this area of corporate
endeavor is not granted as a matter of right but rather as a privilege which
Congress has conferred upon certain transactions and certain taxpayers.
As the Supreme Court has previously noted: "It has been said many times
that provisions granting special tax exemptions are to be strictly construed.
Measured by this sound standard, it is probably not necessary to go beyond
the plain words of . . . [the pertinent tax statute] in search of the
legislative meaning."\textsuperscript{66} In the instant case the Pacific reorganization
in all likelihood was not used as a device to avoid federal income taxes;
however, Pacific's failure to adhere to the rigid requirements of section 355
defeated the tax-free nature of this distribution.

It has been suggested that "[t]he purpose of laying down precise and
detailed requirements [in section 355] was to attempt to achieve an objec-
tive standard for judging the qualification or nonqualification of corporate
separations for tax free treatment."\textsuperscript{67} In applying such objective standards
it is significant to note that the instant transaction involved a publicly held
corporation. While the precise restrictions of section 355 apply to all corpo-
rations, it appears that they are directed primarily at the closely held corpo-
ration because in such a corporate entity a small number of shareholders
dare take in the accumulated profits and these shareholders could easily cause
a spin-off to be utilized as a device to avoid income taxes.\textsuperscript{68} As a solution
Congress could either relax the rigid requirements of section 355 for all
corporations and employ only the device language of subsection 355(a)(1)
(B) to protect against a distribution of earnings masquerading as a capital
allocation,\textsuperscript{69} or make the restrictions which apply to publicly held corpora-

\textsuperscript{65} See notes 40 and 41 supra.

\textsuperscript{66} Helvering v. Northwest Steel Rolling Mills, 311 U.S. 46, 49 (1940). Accord,
Deputy v. duPont, 308 U.S. 488, 493 (1939); White v. United States, 305 U.S. 281,

\textsuperscript{67} Lyons, Some Problems in Corporate Separation Under The 1954 Code, 12

\textsuperscript{68} See generally Cohen, Surrey, Tarleau & Warren, A Technical Revision
of the Federal Income Tax Treatment of Corporate Distributions to Shareholders,
52 COLUM. L. REV. 1, 43-45 (1952). The authors suggest that the widely held corpora-
tion could be treated differently under the reorganization sections than the closely
held corporation.

\textsuperscript{69} Palestin, Tests for Tax-Free Distributions on Corporate Division, 38 TAXES
137, 144-45 (1954).
tions more flexible than they are at present. If the latter approach is taken the active business and complete divestiture requirements should be redefined in terms of the substance rather than the form of the transaction in order to allow a corporation which has a valid business purpose to reallocate its resources without having to face the danger that such a reallocation will be treated as a dividend to its shareholders. It is submitted that the instant case was correctly decided on the narrow issue which the Supreme Court resolved even though the Pacific spin-off transaction probably was not a device designed to distribute earnings. It is further suggested that should another court be confronted with the issues raised in the instant case, the sound analysis employed by the Ninth Circuit should be followed in reaching their proper adjudication.

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70. Cohen, Surrey, Tarleau & Warren, supra note 68, at 43 & n.87. The authors provide a formula for those corporations which can be considered widely held as opposed to closely held.